Mr. Jeroen Dijsselbloem
President of the Eurogroup

Members of the Eurogroup

Copy to:

Mr. Olli Rehn
Vice-President, European Commission
European Commissioner for the
Economic and Monetary Affairs and the Euro

Mr. Mario Draghi
President, European Central Bank

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Dear Members of the Eurogroup,

Lithuania has travelled a long path in preparing to become a fully-fledged, solid member of the Economic and Monetary Union. Our economy has been operating under a currency board arrangement with the national currency pegged to the euro since 2002 and it has been participating in the Exchange Rate Mechanism II since 2004.

Prospective membership in the euro area serves as a roadmap for Lithuania, which will consolidate the prudent fiscal and economic policies that Lithuania focuses on in building a balanced and competitive economy. The credibility of our partnership has been exemplified by our policies over the recent years. Lithuania was able to withstand the global financial crisis without an external financial assistance programme and demonstrated significant internal adjustment capacity. The country's recovered and robust economic growth is taking place in a healthy macroeconomic context: the wage and productivity gap of the boom years has closed, while the current account stays close to the balance.

To ensure Lithuania's successful participation in the EMU, as well as continued sustainable convergence, we are committed to conduct economic policies enhancing macroeconomic stability with a focus on sound counter-cyclical fiscal and macro-prudential policies to prevent the re-emergence of the boom-bust cycles. We will continue to pursue sound fiscal policies in line with the requirements of the Stability and Growth Pact and the Treaty on Stability, Coordination, and Governance in the EMU (Fiscal Compact); to engage in structural reforms that increase Lithuania's economic flexibility, adaptability, and competitiveness; to strengthen the financial sector. These policy commitments are also reflected in Lithuania's latest update of the Convergence Programme for 2014-2017 and the National Reform Programme.

Fiscal policy

Prudent fiscal policy is at the core of Lithuania‘s policy framework to ensure macroeconomic stability. We have brought down the general government deficit from 9.4 percent of GDP in 2009 to 2.1 percent of GDP in 2013. Fiscal consolidation facilitated our successful exit from the excessive deficit procedure in June of 2013.

We are committed to maintain fiscal discipline and build up fiscal buffers in the medium term and have set the corresponding targets in the convergence programme of 2014-2017: the medium-term objective (MTO) of a structural deficit of 1.0 percent of GDP is in line with the Stability and Growth Pact and is planned to be achieved by 2015. The general government balance is projected to reach a surplus of 0.1 percent in 2016 and a surplus of 1.1 percent of GDP in 2017.

The Government will pursue growth friendly fiscal consolidation; in that respect we intend to give priority to growth-enhancing expenditure (investments, R&D) and growth-oriented tax structure over the medium term. In line with the country specific recommendations of the Council, we will review recurrent property and environmental taxation with a view to increase their share in total revenues supporting continuous progress towards the MTO and the creation of sufficient fiscal buffers as well as with an aim to contribute in containing excessive real estate price developments and fostering environmental goals. The focus will also be devoted to possibly reducing labour tax wedge, especially for low wage earners, conditional on better tax compliance in indirect taxation, that is, without compromising the consolidation process; steps in this area have been taken recently by increasing the minimum non-taxable allowance for low wage earners from 2014.

Strengthening tax compliance and tackling the informal (or "shadow") economy will also remain one of the main priorities of the Government to structurally improve public finances. Efforts will concentrate on improving VAT and excise tax compliance, the availability of tax related information to the tax administrator, and reducing levels of non-accounted income. The respective amendments to the Law on Tax Administration and Law on VAT have already passed the first reading in the Parliament in May of 2014. We intend to adopt legislation limiting payments in cash by 2015. In addition, smart tax administration system using latest technologies is expected to be developed in the course of two to five years. The system will consolidate smart electronic cash register, invoicing, excise goods accounting, and risk management systems and should contribute significantly in fostering better tax collection. The financial sector transparency has also been further enhanced recently by strengthening the anti-money laundering/combatting the financing of terrorism (AML/CFT) framework, in line with Moneyval recommendations (respective amendments of Criminal Code have been adopted in 2013; the latest amendments to the Law on the Prevention of Money Laundering and Terrorist Financing have been adopted by the Parliament in May of 2014); the money laundering risks are considered to be low.

Fiscal consolidation in recent years has been underpinned by the Law on Fiscal Discipline, which is in effect since 2007 and has been tested to be effectively operational in setting the budgetary plans. The law has been recently complemented by the amendments to the Law on Budget Structure in 2012, which strengthen the adherence to the tri-annual budgetary planning established by the Parliament. We will aim to further improve budgetary control of all sub-sectors of general government, in particular at the level of municipalities. The respective monitoring capacities at the Ministry of Finance will be reinforced in 2014.

We are devoting significant efforts to further strengthen Lithuania's fiscal framework by transposing the Fiscal Compact and by putting much greater emphasis on planning and achieving fiscal targets in structural terms. To this effect we have prepared a legislative package, which is led by the draft Constitutional Law on implementation of the Fiscal Treaty and is currently reviewed by the Parliament - timely adoption of this legislation is a clear priority for the Government. The Constitutional law will ensure the achievement of general government balance within the meaning of Article 3 of the Treaty on Stability, Coordination, and Governance in the EMU and will bring the annual structural adjustment effort at the forefront of budgetary planning. It is complemented by the creation of an independent fiscal institution, which will be equipped with sufficient resources to execute its tasks.

In order to ensure long-term sustainability of public finances and to cope with challenges of ageing population we have adopted legal provisions based on which the retirement age is gradually increasing annually since 2012 in order to reach 65 by the year 2026. To promote complementary saving schemes we have implemented a pension savings reform, which encourages the use of private pension funds. To further enhance the quality and sustainability of public finances the Government will (i) further enhance efficiency of social spending by a continuing cash social assistance reform, based on greater control and beneficiary targeting at municipal level (actions in this area already reduced ineffective social payments by 27 percent in 2013 compared to 2012), (ii) review and streamline the state pension insurance system by the second half of 2015, including by better alignment of payments into and benefits from the social security system, introduction of pension valuation elements, (iii) continue optimising health care expenditure and programmes, including by assessing the appropriateness of current network of hospitals, of compensation mechanisms for active treatment services in 2014-2016, (iv) carry on with overall expenditure review by streamlining results from existing respective systems and evaluation methods, (v) enhance the use of accrual based planning in the public sector in the medium term, including in state asset management and general government sub-sector budgets.

Structural reforms

To ensure that Lithuania's macroeconomic environment will remain conducive for sustainable economic convergence, Lithuania will continue strengthening financial sector policies and will pursue a structural reform agenda with an emphasis on economic competitiveness and employment. The agenda will focus on:

a) improving business, investment, and innovation environment;
b) enhancing public administration and management of public resources;
c) fostering flexibility and efficiency of the labour market;
d) increasing energy source diversification and efficiency.

The Government is committed to take further steps to improve the business environment. Recent steps in this area include establishment of easier conditions for setting up businesses, improvements in public procurement and territorial planning procedures. These actions have already been recognised by international organisations: in the Doing Business 2014 report Lithuania improved its global ranking by 10 positions as compared to the report for 2013 and now ranks 17th globally.

The Government is committed to maintaining these positive dynamics and will (i) continue monitoring the administrative burden for businesses and prepare two-year term plans to reduce such burden, starting with 2014-2015 plan, (ii) continue the reform of business monitoring infrastructure with an aim to consolidate the number of business control institutions, (iii) promote entrepreneurship and business start-ups, (iv) step-up financing and scope of R&D and innovation with a goal to foster industry's transition towards greater added value production, (v) continue effective use of EU funds in the period 2014–2020, including by employing innovative principles: promotion of effective public-private partnerships, continued use of financial schemes (guarantees, loans) that bring multiplier effects (e.g. during previous programming period over 3,000 SME projects benefited from such initiatives) and a bigger emphasis on regional development (integrated territorial investments).

Lithuania will further modernise its public administration and management of state resources. In this respect, firstly, a comprehensive, results and quality oriented system of civil service pay, motivation, and mobility is being prepared and will be considered by the legislators in autumn of 2014. Secondly, an ambitious reform of State Owned Enterprises (SOEs) is being implemented since 2010. Final legal acts in relation to the separation of data of commercial and non-commercial functions in annual reports of SOEs were adopted in December of 2013. The reform increased SOE transparency via regular reporting obligations and enhanced their efficiency through financial performance goals; the results of the reform can already be observed (e.g. profit of SOE's increased by around 12 percent last year). The Government is committed to complete the implementation of this reform in line with the Council recommendation by closely monitoring compliance with the requirements of the reform. Thirdly, important steps have been taken in creating the centralised state asset management system (the necessary legislation has been adopted in March 2014): two state asset management agencies will be merged into one central agency, which will perform a wide spectrum of functions to ensure the most economically effective use of state real estate and other non-financial assets.

The labour market is an important area of focus for the Lithuanian Government. Tackling unemployment, including youth unemployment, will remain high on the Government's agenda: steps in this area are foreseen in the Employment promotion programme for 2014-2020 also under implementation of EU's Youth Guarantee initiative. Lithuania's labour market has shown its flexibility and adaptability during the crisis period, including in wage adjustment mechanisms, supporting country's competitiveness. The Government will carefully look at factors under its control to safeguard these achievements going forward. Certain employment protection legislation amendments have been enacted to improve the overall efficiency of the labour market in 2009 and 2011; they established more favourable conditions for fixed-term employment contracts, more flexible work time regimes and regulation of individual labour disputes, enhanced the role of temporary work agencies. Further amendments to the Labour Code that lower the administrative burden for employers have been adopted by Parliament in June 2014. The Government is committed to an additional major review of the Labour Code in 2015 (preparatory work has already started) to bring further improvements in the efficiency and adaptability of the labour market with a particular focus on the appropriateness of employment protection in order to attract investment and create new jobs. In addition, active labour market policies will focus on long-term unemployed, attention will be paid to regional coherence of employment policies, skill mismatches will be addressed via identification and promotion of those study and training programmes that face highest market demand.

Lithuania is committed to devote significant efforts to reduce its energy dependence on limited supply resources and increase energy efficiency. Major interconnection projects are in the final stages of implementation: a liquefied natural gas terminal should be completed by the end of 2014 while electric power interconnection projects LitPol link (power interconnection between Lithuania and Poland) and NordBalt (power cable project between Lithuania and Sweden) should be completed by the end of 2015.

In line with the Council recommendation, we have stepped up measures to improve the energy efficiency of buildings - an ambitious programme of both public and private building renovation is underway and tangible progress has been achieved recently. In addition, in 2014 a priority for the Government will be to reduce household heating costs by enhanced use of cheaper local biofuel, which is used for heating energy production. The restructuring of the electricity and natural gas sectors is taking place in accordance with the provisions of the EU Third Package for electricity and gas markets: it involves the separation of transmission activity from distribution, supply and production activities. The restructuring of the gas sector is proceeding according to schedule and is expected to be finished by the end of 2014.

Financial sector

The Government and the Bank of Lithuania are preparing to effectively integrate Lithuania's financial sector into the Banking Union. Lithuanian financial system, with a size of 80 percent of GDP, is dominated by the retail banking sector (4/5 of financial system's assets). The rest of the system consists of leasing, insurance companies and pension funds, while the share of capital market participants and credit unions is marginal. The three largest banks (AB SEB bank, Swedbank, and DNB bank) that would fall under direct ECB supervision are owned by high-rated Scandinavian banking groups and hold more than 70 percent of domestic market. The major sources of banks' funding are domestic deposits and funds from parent banks. Over the recent years loan-to-deposit ratio decreased from 176 percent peak to 105 percent indicating banking sector funding shift towards domestic financial resources. The share of non-resident deposits is minor (3 percent of total deposits) and well diversified among different jurisdictions. Banks in Lithuania undertake traditional retail business model focusing on lending to domestic private enterprises and issuing mortgages. Banking system has made notable progress accommodating non-performing loans (NPL). NPL levels receded two-fold from the peak levels, whereas banks are aiming to clean their balance sheets even further. The strength of Lithuanian banking system is illustrated by the high capital adequacy ratio reaching 17.6 percent.

Lithuania has undergone a significant boom-bust cycle in the past that should be prevented from being repeated. In a currency union where Member States experience heterogeneous financial cycles, the country-level macro-prudential tools are key to address financial and economic imbalances. Currently, the Bank of Lithuania indirectly pursues macro-prudential policy by implementing the Responsible Lending Regulations introduced in 2011. They include two important obligatory macro-prudential policy instruments: the limitations of loan-to-value ratio (LTV) and debt service-to-income ratio (DSTI). Other measures include comprehensive stress tests, mortgage duration limits and safeguards regarding the share of foreign currency denominated loans. Moreover, the cooperation with the home country supervisory authorities has become even closer since the beginning of the crisis.

As a way forward, the finalisation of the institutional and functional macro-prudential policy setup is treated as a top priority. The relevant amendments of the Law on the Bank of Lithuania to grant the Bank of Lithuania the macro-prudential mandate are expected to be adopted during the current parliamentary session. In turn, the Bank of Lithuania is ready to make macro-prudential policy operational pursuing intermediate policy objectives fully in line with the ESRB recommendation (ESRB/2013/1). In addition to LTV and DSTI instruments, a wide macro-prudential toolkit specified in the EU level legislation, is envisaged to apply once the Capital Requirements Directive IV is transposed into our national legislation. It is expected that countercyclical capital buffer application will become fully operational in the end of 2014, whereas interim decision has been made to apply 2.5 percent capital conservation buffer from 2015.

The framework for resolution of financial institutions in Lithuania is effective and operational. Currently, shareholders' and uninsured creditors' loss recognition can be ensured to the maximum extent through a "good-bad" bank split (amendments to the Law on banks introduced in 2011). A fully operational bail-in tool as foreseen in the Bank Recovery and Resolution Directive will be implemented into the national legislation in 2015. Last year, the national competent authorities have successfully resolved the fourth largest bank *AB Ūkio bankas* which faced severe solvency problems by splitting it into "good-bad" bank. The assets of failing bank together with the liabilities consisting of insured deposits up to EUR 100,000 were transferred to the acquiring bank together with the contribution from the Deposit Insurance Fund to match the gap between the assets and liabilities transferred. After the split, the failing bank was placed for liquidation. Decisive actions and efficient resolution process boosted the overall soundness of the entire financial system and ensured minimal financial contribution by the Deposit Insurance Fund, which can legally act as a resolution fund in order to facilitate the restructuring of distressed financial institutions.

Lithuania has decisively embarked on a continuous path of enhancing transparent and efficient bankruptcy procedures. Recently implemented steps such as the new balanced framework of personal bankruptcy law and simplified liquidation of secured assets are directly addressing the lengths and costs of bankruptcy proceedings. Whereas more indirect steps ensuring unbiased administrators' appointment process, resilience against fraudulent bankruptcy cases and provision of effective tools for bringing forward such claims also lead to more transparent and thus less costly procedure for creditors to realise their claims and for debtors to escape the insolvency loop.

On a final note, without pre-empting the legislative process leading to a possible EU Council decision on the adoption of the euro in Lithuania, we have started preparatory work in order to be ready for joining the SSM in line with prospective euro area membership, notably by conducting the Comprehensive Assessment of the three largest banks with all the necessary steps coming in due course.

To sum up, Lithuania is committed to pursue economic, fiscal and macro-prudential policy that is compatible with the principles of the smooth functioning of EMU. We are ready to assume the commitments of euro area membership - deeper coordination and surveillance requirements under enhanced euro area economic governance framework, fully-fledged participation in the European Stability Mechanism, adoption of the provisions of the Treaty on Stability, Coordination, and Governance in EMU, integration into the structures of the Banking Union.

We are ready to work with other euro area Member States in contributing to the stability and credibility of the EMU.

Yours sincerely,

Algirdas Butkevičius Prime Minister of the Republic of Lithuania	Rimantas Šadžius Minister of Finance of the Republic of Lithuania	Vitas Vasiliauskas Governor Bank of Lithuania