VALSTYBĖS KONTROLĖ
BUDGET POLICY MONITORING

To the Seimas of the Republic of Lithuania

OPINION ON THE COMPLIANCE OF THE CURRENT SITUATION WITH THE DEFINITION OF EXCEPTIONAL CIRCUMSTANCES

20 September 2022 No BPE–8

Vilnius

The National Audit Office, implementing its functions of budget policy monitoring institution (hereinafter – Fiscal Institution in the NAO), submits its opinion on the cancellation of exceptional circumstances initiated by the Ministry of Finance of the Republic of Lithuania on 13 September 2022, based on the COVID-19 pandemic, and the establishment of exceptional circumstances in the Republic of Lithuania due to the geopolitical situation and its possible negative impact on the position of general government finances.

In accordance with Council Regulation (EC) No 1466/97 of 7 July 1997, exceptional circumstances are defined as "an unusual event outside the control of the Member State concerned which has a major impact on the financial position of the general government or in periods of severe economic downturn for the euro area or the Union as a whole."

Following the announcement by the European Commission (EC) and the Council that the COVID-19 pandemic can be considered an "unusual event outside the control of the Government", the EU's general escape clause of the Stability and Growth Pact was activated on 23 March 2020. Taking into account the national rules on fiscal discipline, the National Audit Office, implementing the functions of the Fiscal Institution, announced the Opinion on 26 March 2020 on the compliance of the unusual event with the definition of exceptional circumstances[1]. The Lithuanian economy has returned to its pre-pandemic level in Q1 2021, and the impact on public finances of management expenditure of the COVID-19 pandemic is likely to remain limited, therefore the Fiscal Institution in the NAO assesses that the continued validity of exceptional circumstances on this basis is not justified.

The Russian Federation began a war against Ukraine on 24 February 2022. In view of the current situation, the European Commission noted on 23 May 2022[2] that the increased uncertainty to macroeconomic developments due to the war in Ukraine caused by Russia,

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[1] Internet access: https://www.valstybeskontrole.lt/EN/Product/23910/opinion-on-the-compliance-of-the-unusual-event-with-the-definition-of-exceptional.

[2] The EC Spring Package of the European Semester of 23 May 2022. Internet access: https://ec.europa.eu/info/system/files/2022_european_semester_spring_package_communication_en.pdf.

the unprecedented rise in energy prices and the ongoing disruptions in raw materials and supply chains caused by the pandemic justifies the extension of the general escape clause of the Stability and Growth Pact until 2024. During exceptional circumstances, the general government is given the possibility to temporarily deviate from the rules of fiscal discipline as long as this does not endanger fiscal sustainability in the medium term, but does not suspend the validity of the Pact itself. The high uncertainty in 2023 is illustrated by the distribution of the projections of the institutions publishing GDP projections for Lithuania, which is presented in the opinion prepared by the Fiscal Institution in the NAO on the endorsement of the September 2022 Economic Development Scenario.

Taking into account the national rules on fiscal discipline, the National Audit Office, implementing the functions of the fiscal institution, approves the cancellation of exceptional circumstances underlying the COVID-19 pandemic, initiated by the Ministry of Finance, and the compliance of the geopolitical situation in 2022 and its potential negative impact on the financial position of the general government with the definition of exceptional circumstances. It is noted that, in view of the state of public finances, it is necessary to reconsiderthe need for exceptional circumstances before starting the coordination process of the Sempember 2023 Econmic Development Scenario **.**

In the EC decision[2] on the application of the general escape clause it is stated that the aim of the decision is to provide space for national fiscal policy to react promptly when needed. It is also noted that a smooth transition from the broad-based support to the economy during the pandemic times towards an increasing focus on temporary and targeted measures and fiscal prudence required for the medium-term sustainability should be ensured. Non-targeted measures can respond quickly and efficiently to the situation but should not last more than a few months due to the high budgetary burden and the ambition to reduce energy consumption[3]. The Council of Europe[4] notes that new fiscal measures should focus on alleviating the supply-side constraints that are holding back our economies, not on stimulating aggregate demand. The European Central Bank[5] emphasizes that incentives should be geared towards reducing the use of fossil fuels and dependence on Russian energy, while maintaining sound public finances.

The Fiscal Institution in the NAO notes that horizontal, i.e., population-centred measures (e.g., compensation for gas and electricity prices) are expensive and not sufficiently grounded from an economic point of view , and their application reduces incentives for rational use of resources[6]. In addition, it discourages investment in improvement in energy efficiency and alternative energy sources, the development of which could also be supported by EU funds. In order to manage risks related to public finances, targeted measures focused on the most vulnerable groups in society are justified or, in order to respond quickly to the changes of the situation, horizontal, but temporary. During the COVID-19 pandemic, the Fiscal Institution in the NAO[7] noted that in Lithuania 80% of the

[3] The European Parliament. Internet access: https://www.europarl.europa.eu/RegData/etudes/IDAN/2022/699543/IPOL_IDA(2022)699543_EN.pdf.

[4] 11/07/2022 Eurogroup statement on fiscal policy orientations for 2023. Internet access: https://www.consilium.europa.eu/en/press/press-releases/2022/07/11/eurogroup-statement-on-fiscal-policy-orientations-for-2023/. The importance of the support for the implementation of structural reforms and supporting investments focused on the green and digital transitions is noted.

[5] Internet access: https://www.ecb.europa.eu/pub/economic-bulletin/focus/2022/html/ecb.ebbox202205_07~6db6f2c297.en.html.

[6] This has already been mentioned by the Fiscal Institution in the NAO in its Opinion No BPE-3 of 5 May 2022. This is also the position of the International Monetary Fund (IMF) presented in its report to Lithuania published on 28 July 2022.

[7] Fiscal Institution in the NAO's Report No BPE-2 of 12 May 2021 Assessment of the Stability Programme of Lithuania for 2021.

total 2020 COVID-19 package (17% in the euro area) consisted of budgetary measures: subsidies, social payments, various compensations of expenses incurred by companies, etc. This nature of the support has led to a significant increase in the general government deficit and debt level, while a decrease in the number of bankruptcies indicated an increase in the number of zombie companies. In light of this experience and the current situation, relying more on measures having an indirect impact on the general government balance, such as guarantees or loans, could lead to a significantly lower deficit and debt towards the medium term. Meanwhile, subsidies can affect the competitive environment[8], are costly, and reduce the incentives for efficient use of resources. In case of a prolonged surge in energy prices[9], support measures may become unbearably costly, which is why it is already worth paying more attention to finding long-term solutions. In addition to these challenges, general government finances will also be affected in the medium term by rising long-term expenditure on social benefits, wages and the need to increase the budget for defence.

Public finances should be used in a particularly responsible manner in the face of risks of growth of general government debt. Against the backdrop of raising of interest rates by the European Central Bank and the war in Ukraine, Lithuania's borrowing costs are rising. As a result, previously issued low-cost Government securities might have to be replaced by more expensive ones, general government finances are becoming more vulnerable; therefore, it is important to ensure the efficient use of funds. Compared to Q1 2020 and Q1 2022, debt increased by 43.6% (up to EUR 23.3 billion) in nominal terms, however, remaining economic growth and low interest rates contributed to a lower-than-expected increase in the debt-to-GDP ratio: this indicator increased by 7.5 p.p., reaching 40.3% of GDP in Q1 2022. Current tense situation indicates that in the future there might be fewer this kind of favourable factors: it is possible that the country's economic growth will not be as strong in the medium term and interest rates will be higher. During the period of exceptional circumstances, deviations from the normally applied requirements for the general government budget are allowed, but medium-term fiscal sustainability should not be overlooked and a view to restore fiscal space and reduce debt should be envisaged. A debt management strategy could contribute to this objective. In the face of significant negative risks, public finances must be used in a particularly responsible manner.

Pursuant to Article 8(7)(4) of the Law on National Audit Office and to Article 7(2) of the Constitutional Law on the Implementation of the Fiscal Treaty, the National Audit Office of the Republic of Lithuania, implementing the functions of the budget policy monitoring institution, submits its opinion on the compliance of the current situation with the definition of exceptional circumstances, taking into account letter No (5.41Mr)-6K-2205430 of 13 September 2022 submitted by the Ministry of Finance on lifting and initiating exceptional circumstances. At the same time, an opinion is drawn on the endorsement of the September 2022 Economic Development Scenario.

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[8] 03/08/2022 IMF Blog article How Europe Can Protect the Poor from Surging Energy Prices. Internet access: https://blogs.imf.org/2022/08/03/how-europe-can-protect-the-poor-from-surging-energy-prices/.

[9] The National Energy Regulatory Council warns that high energy prices may not only persist next year but are likely to continue in 2024.