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Republic of Lithuania: Staff Report for the 1999 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of the Republic of Lithuania on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with the Republic of Lithuania, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of the Republic of Lithuania; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Public Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date.

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REPUBLIC OF LITHUANIA

Staff Report for 1999 Article IV Consultation

Prepared by the Staff Representatives for the
1999 Consultation with the Republic of Lithuania

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July 12, 1999

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Lithuania: Basic Data

Social and demographic indicators (latest available data)	
Area (sq. km)	65,300
Population density (inhabitants per sq. km.)	56.68
Population (thousands)	3,701.3
Life expectancy at birth	
Men	65.0
Women	76.2
Infant mortality rate (per 1,000 births)	9.3
Hospital beds (per 1,000 inhabiants)	9.6
Physicians (per 1,000 inhabitants)	4.0

	1994	1995	1996	1997	1998
	(In percent of GDP)				
National accounts					
Domestic demand	106	112	110	111	112
Consumption	88	87	85	84	86
Gross investment	18	25	25	27	26
Current account balance	-2	-10	-9	-10	-12
GDP	100	100	100	100	100
	(Percentage change from previous period)				
Real GDP	-9.8	3.3	4.7	7.3	5.1
GDP (in millions of litai)	16,900	24,100	31,600	38,300	42,800
Consumer prices (end-period)	72.2	35.5	13.1	8.4	2.4
Real wages 1/	14.2	3.2	4.1	13.9	14.7
Labor market					
Total employment (thousands)	1,675	1,644	1,659	1,669	1,656
Of which: in state sector	645	600	555	539	517
Unemployment rate (in %) 2/	3.8	6.1	7.1	5.9	6.4
	(In millions of U.S. dollars)				
Balance of payments 3/					
Trade balance	-204	-698	-896	-1,147	-1,518
Current account balance	-94	-614	-722	-981	-1,298
	(Percentage change from previous period)				
Money and credit					
Broad money	63	29	-4	34	15
Credit to private sector	6	23	-4	19	17
Interest rate (in percent) 4/	29	26	15	12	17
	(In percent of GDP)				
General government finances					
Revenues	32.6	32.3	29.6	32.6	34.1
Expenditure and net lending	37.4	36.8	34.1	34.3	39.3
Financial balance	-1.2	-2.6	-2.5	-0.8	-4.3
Fiscal balance	-4.8	-4.5	-4.5	-1.8	-5.8

Sources: Data provided by the Lithuanian authorities; and Fund staff estimates.
1/ Average wage deflated by consumer price index.
2/ Calculated on the basis of registered unemployment; end of period.
3/ Balance of payments prior to 1996 are not comparable data.
4/ Rates on 30-90 day credits. Data refer to end of period.

Executive Summary

Since regaining independence, Lithuania has made impressive progress in macroeconomic stabilization and market transition. Since its introduction, the currency board arrangement has been combined with fiscal restraint and structural reforms, resulting in low inflation and resumption of economic growth.

The progress in economic performance has suffered setbacks in the wake of the Russian crisis as a result of lower exports, which weakened growth and initially increased the current account deficit. Also, Lithuania has experienced financial contagion from international capital markets, while the direct effects through the domestic banking system have been limited. Economic policies since mid-1998 have involved fiscal easing, interventions to cushion the impact of the Russian crisis on enterprises, and postponement of the currency board exit.

The discussions focused on the authorities' decision to keep the currency board in place at the present exchange rate, and its fiscal policy implications. The authorities recognized the need to reduce the current account deficit, and explained that their strategy would rely on fiscal adjustment and export promotion.

Because the international environment remains unsettled, the authorities are not currently considering an exit from the currency board. Future exchange rate and monetary policy will be laid out in a new Monetary Policy Program, to be drawn up in late 1999. External competitiveness remains adequate, although there is little room for further real appreciation or wage increases that are not related to productivity growth.

The authorities recognize that fiscal policy will need to be the central instrument for reducing the current account deficit in the near term, and are formulating the revised 1999 budget and the 2000 budget with this in mind. Fiscal adjustment is being supported by reforms relating to use of privatization proceeds, budgetary control, and tax administration.

The structural reform agenda represents a continued effort towards establishing a fully functioning market economy, with the focus on pension reform, transparent privatization, hard budget constraints on state enterprises, energy and agricultural sector reforms, liberal trade policy, and efforts to safeguard financial sector stability. The new government recognizes that transparency in economic policies will be critical for market confidence and for public support.

The macroeconomic outlook is favorable, but is not without risks. Fiscal adjustment and market reforms should help Lithuania return to high sustained growth and achieve a viable external position. Even so, adverse exogenous developments or lack of follow through on economic policies could jeopardize orderly external adjustment and lead to lower economic growth. If Lithuania were faced with such developments, strengthening of fiscal policy and reinforced structural reforms would be called for.

I. INTRODUCTION

1. **Missions visited Vilnius May 11–25 and June 23–25, 1999 to conduct the 1999 Article IV consultation discussions.**[1] The missions met with President Adamkus, Prime Minister Paksas, acting Finance Minister Šemeta, Finance Minister Lionginas, Economy Minister Maldeikis, Social Security Minister Degutiene, Bank of Lithuania Governor Šarkinas, and representatives of government institutions and the banking and business communities.

2. **The 1998 Article IV consultation was concluded on July 13, 1998** (SM/98/150 and SM/98/156). Executive Directors noted that the main challenges facing the authorities were to sustain the favorable performance and reduce the vulnerability of the economy to external shocks. They expressed concern about the large current account deficit and low national saving. Directors called for fiscal policy restraint focused on expenditure control, meeting the conditions for an orderly currency board exit, strengthening of the banking system, and revitalization of privatization and further measures to promote restructuring.

3. **In the absence of a Fund-supported program, Fund relations with Lithuania have involved an active economic policy dialogue, supported by technical assistance.** This dialogue with the authorities was intensified, at the authorities' request, in the context of staff visits after the Russian crisis, and Mr. Sugisaki visited Vilnius in November 1998. The last Fund arrangement, an extended arrangement, expired in October 1997 (Appendix I); the authorities have indicated an interest in a new Fund-supported program. Lithuania has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement and maintains an exchange system that is free of restrictions on payments for current international transactions. The Fund has continued to provide technical assistance (Appendix II). The Eleventh Quota Review was approved by Seimas in January 1999, and legislation relating to the Fourth Amendment to the Articles of Agreement will be presented to Seimas in the autumn session. The authorities wish to participate in the pilot study for the public release of staff reports.

4. **The Bank and Fund staff working on Lithuania collaborate closely**. The World Bank Board approved a Country Assistance Strategy for 1999–2001 in May 1999. The Bank will assist Lithuania in (i) maintaining macroeconomic and financial stability (the Bank has recently carried out a Macroeconomic and Financial Sector Vulnerability Review), (ii) implementing the EU agenda, and (iii) designing social safety net and human development programs. World Bank relations are summarized in Appendix III.

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[1]The team comprised O.P. Brekk (head), M. Farahbaksh, G. Taube (all EU2), T. Lybek (MAE), and A. Senhadji (INS), and was assisted by A. Knöbl, the Fund's senior resident representative. J. Odling-Smee (Director of EU2) and K. Aaen Hansen (Executive Director for Lithuania) participated in some of the policy discussions.

5. **Lithuania's economic database is generally adequate for surveillance purposes,** although large revisions to balance of payments and national accounts data complicate macroeconomic analysis and underscore the need for improvements (Appendix IV). Data are available on the web sites of the Bank of Lithuania (BOL), the Ministry of Finance, and the Department of Statistics. Lithuania subscribes to the SDDS.

6. **The government changed in mid-1999**. Amidst public criticism of economic policies, Prime Minister Vagnorius announced his resignation on April 30. The new government, a center-right coalition headed by Rolandas Paksas of the Homeland Union Party, assumed office in June. The new government has adopted the outgoing government's program with few changes. Economic policies will continue to be guided by the drive to join western economic and security organizations. Parliamentary elections are scheduled for the autumn of 2000.

II. Recent Economic Developments

7. **Since regaining independence, Lithuania has made impressive progress in macroeconomic stabilization and market transition**. Following the introduction of the currency board in April 1994, which has been supported by fiscal restraint for most of the subsequent period, inflation has come down rapidly. At the same time, market reforms have provided a sound basis for economic growth. Nevertheless, GDP per capita is modest, and as much as one-fifth of the population is below the national poverty line, suggesting that an equitable increase in living standards should be a goal in the years ahead.

8. **The progress in economic performance suffered setbacks in the wake of the Russian crisis**. The main transmission mode of the Russian crisis has been through lower exports, which weakened economic growth and initially increased the current account deficit.[2] Also, Lithuania has experienced some financial contagion through international capital markets, while the effects through the domestic banking system so far have been limited. Economic policies since mid-1998 have involved fiscal easing, interventions to cushion the impact of the Russian crisis on enterprises, and a postponement of the exit from the currency board (Box 1). External and financial vulnerability increased following the August 1998 events, but has since declined (Appendix V).

A. Growth, Inflation, and the Balance of Payments

9. **The economy cooled rapidly starting in the third quarter of 1998**. Real GDP growth came to a halt by the fourth quarter of 1998, while preliminary data suggest that real GDP fell by 5¾ percent year-on-year in the first quarter of 1999 (Table 1 and Figure 1).

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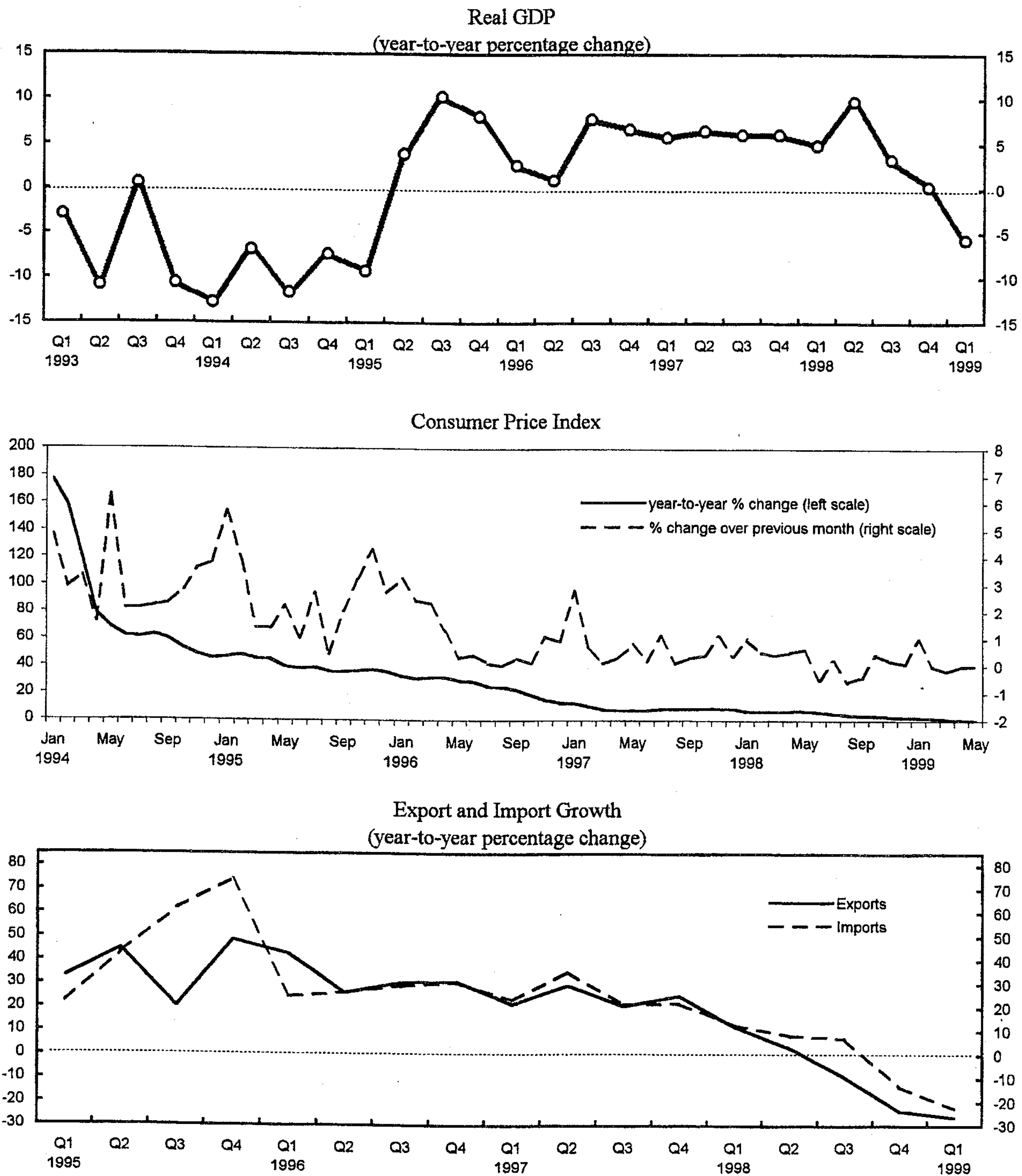
[2]The share of CIS exports was 46 percent of the total in 1997.

Box 1: Status of Currency Board Exit Strategy

The Bank of Lithuania (BOL) approved on January 16, 1997 the *Monetary Policy Program of the Bank of Lithuania for 1997-99*, which laid out a three-stage strategy for an exit of the currency board arrangement (CBA) consistent with the *Program of the Government of the Republic of Lithuania for 1997-2000*. The CBA is established by the Law on the Credibility of the Litas that came into force on April 1, 1994. The exit strategy's principal objective is strengthening economic links with the EU, ultimately leading to membership of the European Monetary Union (EMU).

Actions	Original Timing	Current Status of Implementation
First stage: The BOL will gradually develop monetary policy functions by assuming a more important role and responsibility in the evolution of the national economy, while keeping the CBA in place.	**To start in 1997**.	**Ongoing.**
- **Amend the central bank law** with a view to strengthen central bank autonomy and accountability in line with EU requirements, and make price stability its primary objective.	To start in 1997.	Amendments were drafted by the BOL in 1997, but have not yet been sent to the legislature.
- **Introduce monetary policy instruments** with a view to harmonize monetary instruments with those of the European Central Bank.	To start in early 1997.	Ongoing: (1) repurchase operations in T-bills initiated in June 1997; (2) time-deposit auctions initiated in August 1997; (3) lombard facility came into operation in 1998; and (4) introduction of BOL bills currently being considered.
Second stage: Restore fully flexible monetary policy; the BOL will orient its activities toward net domestic assets.	**Second half of 1997 at the earliest.**	**Not being actively considered**; a new Monetary Policy Program to be drawn up in late 1999.
- **Amend the Law on the Credibility of the Litas** to broaden the range of assets used to back the currency. The law will ensure convertibility, the BOL will maintain the exchange rate (Litas 4 = US$) with a view to guarantee public confidence, and comprehensive measures are envisaged to avoid significant declines in international reserves.		Depending on the new Monetary Policy Program, amendments may be presented to the legislature in late 1999. The BOL has begun to gradually diversify its international reserves to reflect an increased share of EU currencies. At end-April 1999, gross international reserves amounted to 141 percent of litas liabilities.
- **Coordinate closely with the government**, including domestic debt policy.		Ongoing. Savings bonds introduced in April 1999.
Third stage: The litas exchange rate will be targeted to ensure integration with the EMU.	**No earlier than 1999**. Stable credit and money markets planned for the first half of 1999. The transition to "euro-only" is envisaged not to exceed two years.	**No decision to be taken until late 1999.** The possible move to peg the litas to a 50-50 euro and dollar basket unlikely to take place earlier than 2000.
- **Peg litas to either the euro or a basket composed of the euro, U.S. dollar, and perhaps some other European currencies.** The necessary conditions are macroeconomic and financial stability, including: monthly inflation not to exceed 0.5- 0.8 percent for six months in a row; and steady growth in bank deposits.		Average monthly growth CPI inflation 0.1 percent (Dec.-June) (but not 0.5-0.8 percent in a row) Total bank deposits 1.3 percent (Nov.-May) Total bank deposits in litas 1.1 percent (Nov.-May)

Figure 1. Lithuania: Growth, Inflation and Trade



Sources: Lithuanian Department of Statistics; Bank of Lithuania.

Initially, the downturn was driven by a drop in exports, but lower domestic demand played an important role afterwards, notwithstanding an expansionary fiscal stance.

10. **Inflation continued on a downward trend and wage increases slowed markedly.** Reorientation of food supplies from the Russian to the domestic market, appreciation of the litas against the currencies of western European trading partners (the litas is pegged to the U.S. dollar), and softer domestic demand all contributed to a decline in inflation to a 12-month rate of one-half of 1 percent by June. Reflecting the flexibility of wages, the weaker economy led to a reduction in 12-month wage growth from about 30 percent in early 1998 to 7¾ percent in May 1999. Recorded unemployment reached its highest post-independence level of 8½ percent in March, before registering a seasonal easing to 7½ percent in June.[3]

11. **The current account deficit widened in the second half of 1998, but has since contracted sharply.**[4] Recorded *exports* fell in the second half of 1998, as exports to the CIS declined by 50 percent year-on-year. By contrast, exports to the West continued to grow rapidly (EU exports grew by 12½ percent). A sizable part of the decline in exports was related to re-exports to Russia and other CIS markets.[5] Both weaker domestic demand and the drop in re-exports were reflected in lower *import* growth in the latter part of 1998. The *services balance* improved in 1998, boosted by tourism and business services receipts. Overall, the *current account deficit* widened from 10½ percent of GDP in the first half of 1998 to 13¾ percent in the second half, yielding an annual deficit of 12 percent of GDP in 1998 (Table 2 and Figure 2). Preliminary data suggest that the current account deficit fell to 9½ percent of GDP in the first quarter of 1999, as imports declined further.

12. **The current account deficit has continued to be financed mainly by FDI and medium- and long-term borrowing.** As privatization of large enterprises got under way (see paragraph 18 below) FDI was bolstered, and covered three-fourths of the current account deficit in 1998. The government returned to the euro bond market quickly after the Russian crisis, with two small bond issues in late 1998 and a five-year euro 200 million bond issue in March 1999. The FDI inflows moderated the external debt accumulation, as external debt increased from 25¾ percent of GDP at end-1997 to 26½ percent at end-1998, and helped

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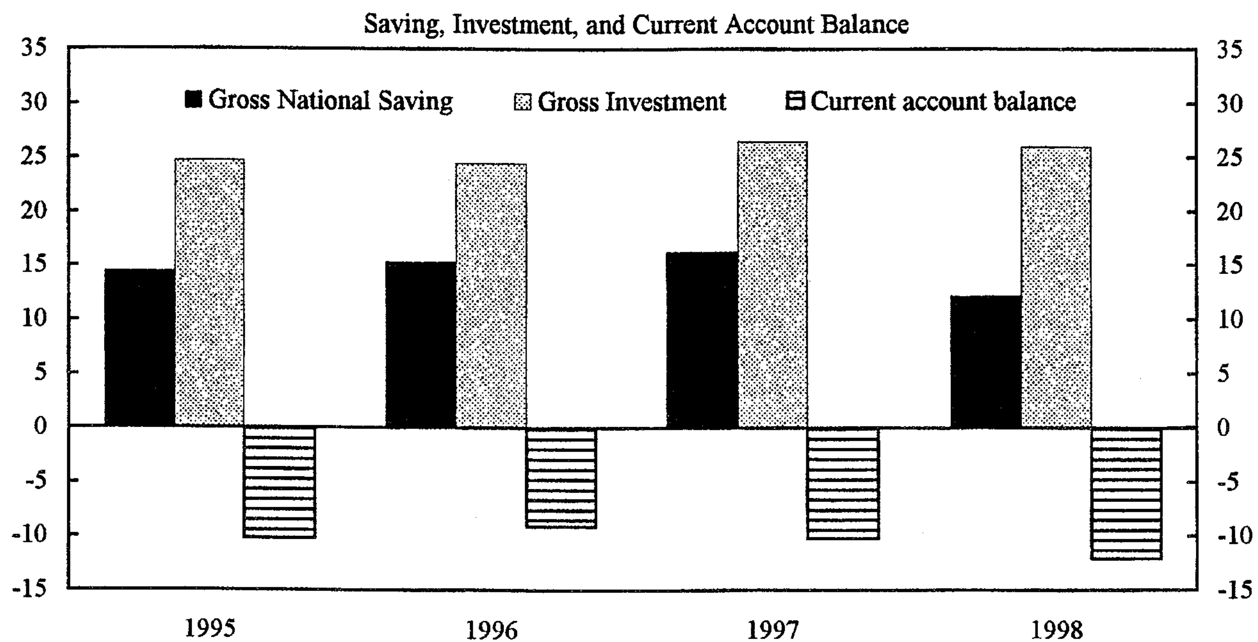
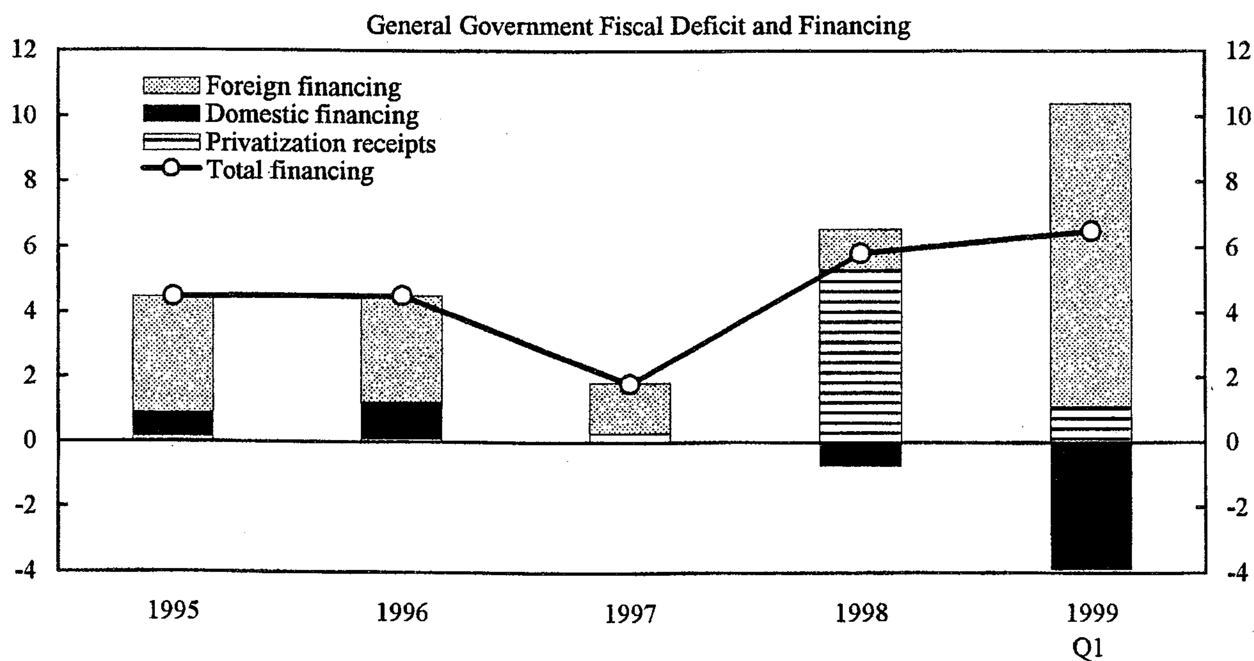
[3]Labor market surveys indicate that the actual level of unemployment is about twice registered unemployment.

[4]The balance of payments data when first published often include a large positive errors and omissions term. The errors and omissions term typically relates to under-recorded exports and one-off transactions, both on the current and financial accounts, that routine data collection at first fails to capture.

[5]For the year as a whole, the overall decline in exports was 5½ percent, but only ½ percent when re-exports are excluded.

Figure 2. Lithuania: Saving and Investment, Current Account Balance, and Government Balance
(In percent of GDP)





Source: Lithuanian authorities; and Fund staff estimates.

improve substantially the international reserves coverage in relation to short-term external debt and reserve money.

B. Fiscal Developments

13. **Fiscal policy became more expansionary starting in mid-1998, reflecting in large part spending of privatization proceeds**. While central government expenditure stayed within the limits approved by Seimas, the government spent privatization proceeds on off-budget items in the second half of 1998. The most important items were the Savings Restitution Plan (SRP—Box 2) and support for companies affected by the Russian crisis.[6] The general government fiscal deficit increased from 2 percent of period GDP in the first half of

Box. 2: The Savings Restitution Plan

In the aftermath of the hyperinflation period of 1991–92 and the administrative restrictions on withdrawal of deposits that were imposed during that period, the government announced in 1993 a plan to compensate losses for deposits in the state banks. Over the period 1993–95, some LTL 226 million (1.9 percent of 1993 GDP) was transferred to depositors.

The government started a second Savings Restitution Plan (SRP) in the fourth quarter of 1998. Under the Plan, the amount of compensation per depositor is determined by taking the smaller of the deposit balances on one of three test dates and applying a multiplicative factor, and netting out any amounts already paid out during the 1993–95 period. Compensation is paid out to individual depositors, not accounts, as had been the case in 1993, and is financed by privatization proceeds. According to the Savings Restitution Law, two-thirds of privatization proceeds are earmarked for restitution of savings. The total cost of the compensation package is estimated at about LTL 3.6 billion, to be paid out over time. In the first round in November 1998, depositors over 85 years old, the disabled, former political prisoners, and persons who were victims of World War II occupation received a total of LTL 445 million (1 percent of GDP). In the second round, in February–April 1999, the government transferred LTL 904 million (2 percent of GDP) in two tranches to persons over 70 years old and families with four or more children and the disabled.

The authorities have taken a number of measures to encourage saving and limit the macroeconomic impact of the transfers, including (i) the payment of a subsidized above market interest rate on restituted deposits at the Savings Bank; (ii) the establishment of a time limit for depositors to apply for the withdrawal of their deposits; and (iii) the introduction of retail savings bonds. In addition, the BOL has increased the use of deposit auctions to offset the liquidity effect of the SRP.

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[6]In particular, the government extended a loan of US$64 million (½ percent of GDP) to Mazeikiai oil refinery in September 1998, when a foreign lender exercised a put option following the Russian crisis; the loan was rolled over in December 1998 and March 1999.

1998 to 9 percent in the second half (Table 3).[7] On an annual basis, the fiscal deficit rose to 5¾ percent of GDP in 1998. In January–May 1999, weak revenue due to the decline in economic activity, SRP payments, and net lending operations (including loans to the oil sector) contributed to a fiscal deficit of 4 percent of projected annual GDP.

14. **The fiscal expansion was driven by a sharp increase in current spending.** Spending on goods and services jumped in 1998, while use of privatization proceeds on a range of government programs (including subsidies to households, and support for agricultural and other enterprises) increased. Also, social expenditures went up in the wake of the Russian crisis, complicating the financial position of SoDra. Moreover, strong wage growth led to an increase in the wage bill, from 8¾ percent of GDP in 1997 to 10 percent in 1998, a share of GDP that is in the upper end of the range for middle-income countries. Capital expenditures, by contrast, remained below 3 percent of GDP in 1998.

15. **Government revenue held up in 1998 and tax administration improved**. Revenue increased to 34 percent of GDP from 32½ percent in 1997, as the effect of the slowdown in the economy was offset by the impact of strong wage growth on payroll and income tax collection. Tax collection was helped also by several initiatives to improve tax administration in 1998, including upgrading of information systems (e.g., information sharing between SoDra and the State Tax Inspectorate), closer collaboration between the STI and the Tax Police, concentration of payroll tax collection at SoDra's headquarters, and streamlining of regional tax services.

C. The Currency Board and Monetary Developments

16. **The currency board has withstood pressures caused by the recent turmoil in international markets**. Starting in September 1998, there were net foreign exchange sales to commercial banks through the currency board (Figure 3). Initially, the automatic functioning of the currency board mechanism led to an increase in treasury bill interest rates, from 8¾ percent in July to about 14 percent in October (on three-month bills). From October onwards, however, the government used privatization funds held at the BOL in lieu of treasury bill issues to meet part of its financing need and drew on privatization funds also for the SRP payments, while the foreign exchange sales through commercial banks tapered off. By June 1999, interest rates had declined to 9–10 percent. The foreign exchange coverage under the currency board has remained comfortable, at about 143 percent of litas liabilities at end-May 1999 (compared with 127 percent at end-1997 and 144 percent at end-1998).

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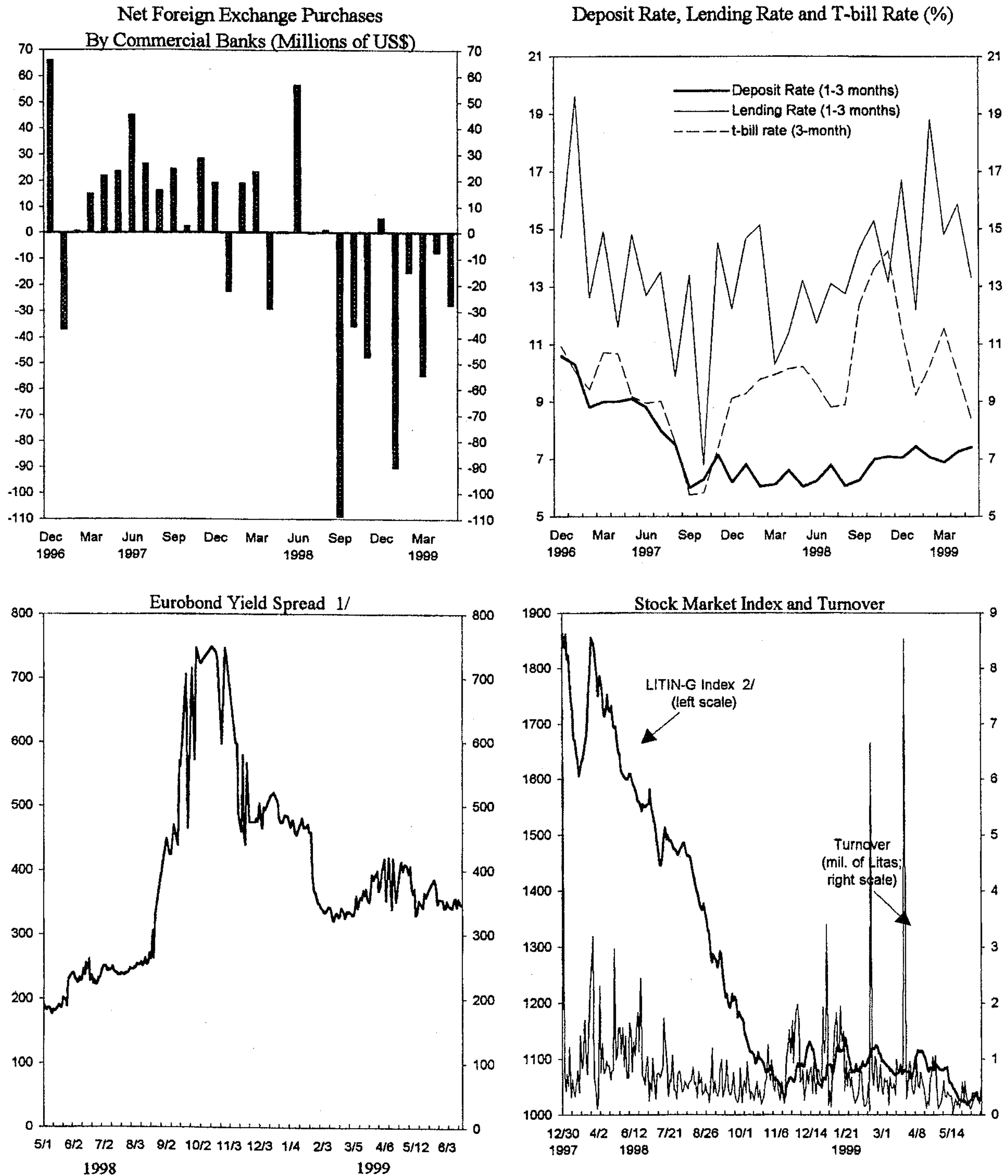
[7]The IMF definition of the general government includes the state and local governments, as well as extra-budgetary funds such as the social insurance fund (SoDra), the Health Insurance Fund, and the Privatization Fund. Privatization proceeds are treated as financing, while spending of such proceeds is counted against the deficit (Box 3).

Figure 3. Lithuania: Financial Indicators



Sources: Bank of Lithuania; Bloomberg news; and National Stock Exchange of Lithuania.

1/ Yield spread between Lithuanian Eurobond and U.S. bond; Lithuanian Eurobond maturing July 2002.

2/ Calculated from all issues quoted in the current trading list in the last three months, excluding treasury bills and investment companies.

Box 3. Privatization Proceeds and Budget Indicators

Privatization programs have effects on the budget and the economy both through their impact on government finances and private sector behavior. A key question is whether the proceeds should be viewed as government revenue or as government financing.

Accounting for privatization proceeds. In principle, the treatment of privatization proceeds would depend on the extent to which the government's net worth is affected by the privatization transaction. In a case where the physical assets sold have no (or negative) value in the hands of the government (e.g., a company that is inefficiently run by the public sector), privatization increases the government's net worth and loosens its intertemporal budget constraint, similar to a tax increase. This is because the amount of cash that the government receives for the physical assets exceeds the value of the assets in terms of future revenue to the budget. In another case, the government might receive cash and give up a positive stream of future earnings on the assets of equal value. In this case, the privatization would merely involve a one-time shift in the composition of the government's assets. Privatization, in this event, does not change the net worth of the government and, unlike a tax increase, leaves the government's intertemporal budget constraint unaffected. In most cases, privatization transactions would tend to be closer to the latter case, which argues for treating privatization proceeds as financing in the budgetary accounts. Also, in doing so, the government would be able to take out from "above the line" the temporary and one-off effect of privatization in order to have a better grasp of the underlying fiscal deficit. Furthermore, to the extent that privatization involves foreign investors, the "domestic fiscal deficit" (which excludes privatization proceeds from revenue and includes the domestic spending of such proceeds) may be a useful budget indicator.

Use of privatization proceeds. The macroeconomic effects of privatization also depend on what the government does with the proceeds. The proceeds can be used (i) to reduce tax income or increase government spending, which increases the fiscal deficit, or (ii) to retire government debt, in which case the fiscal deficit would be lower to the extent that interest payments are lowered (the retirement of debt would be accounted for as negative budgetary financing). If privatization proceeds were used to finance an increase in the fiscal deficit, the effects would be similar to a debt-financed fiscal expansion; i.e., domestic demand would increase with resulting pressures on domestic prices and the external current account. If the proceeds were used to reduce government debt (foreign or domestic), there would be no direct effect on domestic demand, while the budgetary position would become less exposed to shifts in market sentiment. In cases where privatization is financed from abroad, the use of the proceeds to finance the fiscal deficit involves the exchange of foreign currency for domestic currency, which would tend to increase domestic money and credit creation and in turn spur domestic demand. In that sense, the use of privatization proceeds amounts to a discretionary "monetary policy" stimulus.

Budgetary management. Decisions on the use of privatization proceeds also need to take account of practical implications for budgetary management. In particular, treating privatization proceeds as revenue runs the risk that spending becomes entrenched at a level that exceeds the underlying revenue-generating capacity of the government. To deal with this problem, governments at times earmark privatization proceeds for specific expenditures, and exclude the proceeds and the associated spending from the budget. This allows one-off spending to be linked with the receipt of one-off privatization proceeds, and may thus help prevent spending from being ratcheted up on a permanent basis. However, this approach runs the danger of under-estimating the effects of government transactions on the economy and impairing macroeconomic analysis. While earmarking might help avoid a permanent increase in spending, it would be advisable to include the earmarked spending in the budget when analyzing its macroeconomic effects.

Transparency in budget formulation. Excluding privatization proceeds from the budget would tend to diminish fiscal policy control and transparency. This approach could impair parliamentary influence, as the use of privatization proceeds would not be subject to priority setting as part of the annual budget process, and the budget decisions would not be fully open to scrutiny by Parliament and the public.

17. **The re-monetization process following the 1995/96 banking crisis has continued.** The growth in bank credit to the nongovernment sector was brisk through mid-1998, but slowed in the second half of 1998 as banks became more cautious in their lending practices following the Russian crisis (Table 4); the banks' greater caution was reflected also in an increase in interest spreads. The expansion of overall net domestic assets of the banking system in 1998 was moderated by the partial saving of privatization proceeds at the BOL and commercial banks. Moreover, the BOL sought to moderate the liquidity impact of the use of privatization proceeds by stepping up the use of deposit auctions.[8] Overall, broad money grew by 14½ percent in 1998, mainly reflecting an increase in net foreign assets, and velocity fell from 6 at end-1997 to 5½ at end-1998. In early 1999, as credit growth recovered and SRP payments were stepped up, broad money growth accelerated, reaching 20 percent in May.

D. Structural Reforms and Financial Sector [9]

18. **Recent progress in privatization has been good**. The Privatization Agency has been restructured as called for under the Privatization Law enacted in December 1997, and privatization has been facilitated by a new Law on Foreign Investment. The Agency completed 345 privatization transactions with a total value equivalent to 5⅓ percent of GDP in 1998 (Figure 4). In particular, sale of large enterprises in the energy, telecommunications, and transport sectors were undertaken; the largest privatization transaction was the sale of a 60 percent stake in Lietuvos Telekomas (for US$500 million). Privatization continued apace in early 1999, with the sale of a stake in the oil sector complex at an advanced stage.[10]

19. **Sectoral reforms in energy and agriculture have lagged**. The *electricity sector* has experienced intensifying cash flow problems, because of inefficiency and high costs, lags in adjusting tariffs, and difficulties in collecting payments on exports. In early 1999, Seimas approved a government take-over of energy-sector debt. In *agriculture*, the government's progress in reducing subsidies and distortionary state support has suffered setbacks against the background of low world commodity prices and a severe impact on food industries of the Russian crisis.

20. **The government has provided ad hoc support to enterprises, and weaknesses in the framework for market entry and exit have tended to soften enterprises' budget constraints**. Following the Russian crisis, the government adopted a set of anti-crisis

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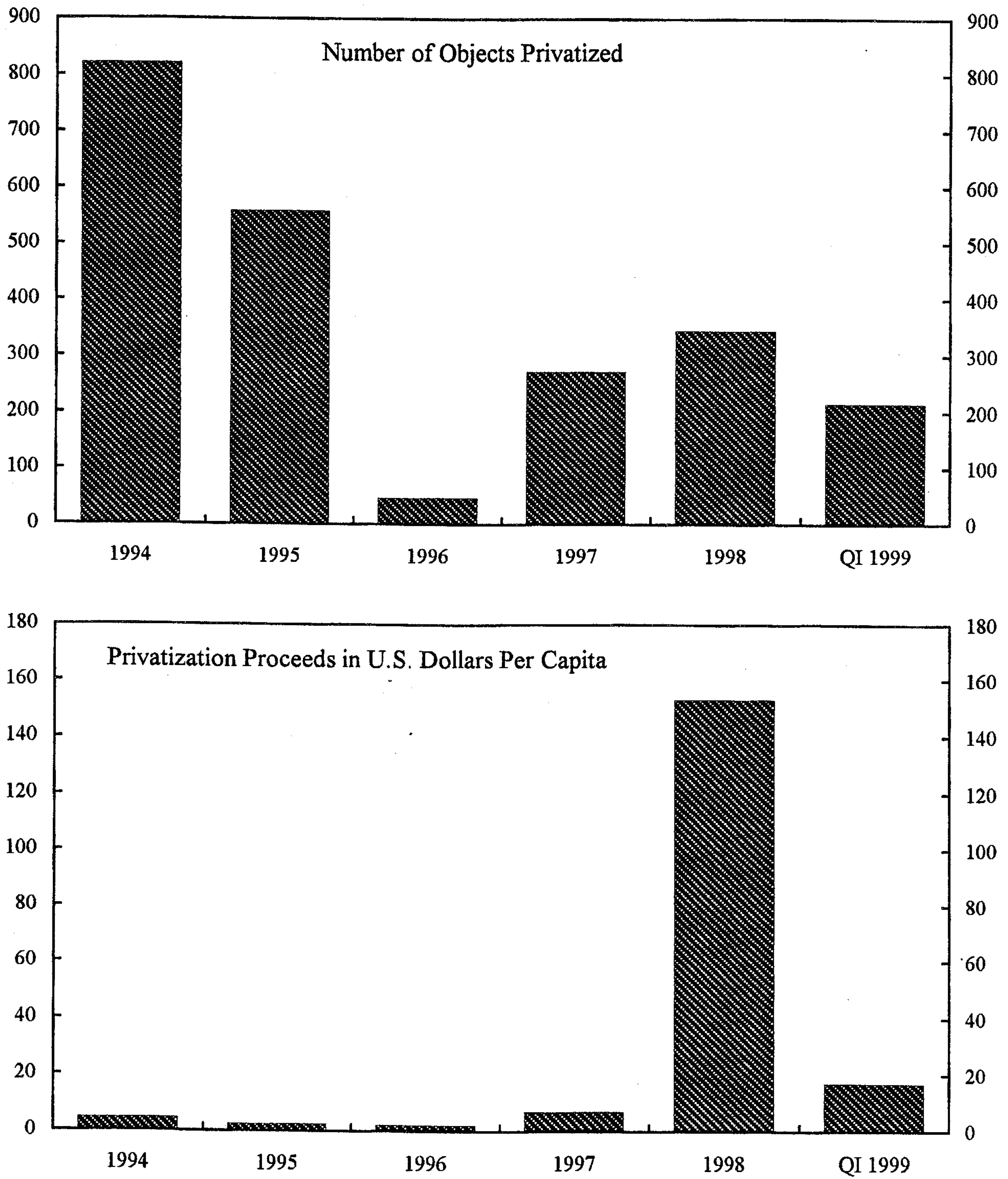
[8]Besides the deposit auctions, the BOL's monetary policy instruments include a Lombard facility (primarily intended for overnight clearing purposes), repurchase operations, and reserve requirements.

[9]The accompanying Background Paper provides a detailed overview of structural reforms.

[10]The complex consists of an oil refinery, offshore oil terminal, and oil pipeline.

Figure 4. Lithuania: Privatization Indicators, 1994-Q1 1999



Source: State Property Fund.

measures, that included changes in public procurement in favor of Lithuanian suppliers and support for agriculture and other sectors in the form of import protection and budget assistance. Government regulations and licensing requirements continue to hamper the starting of new enterprises.[11] Moreover, bankruptcy cases are moving slowly because of a lack of skilled liquidation managers and rigidity in asset pricing. On the positive side, a new Competition Law, bringing legislation closer to EU standards, was adopted in April 1999.

21. **The banking system has generally withstood the Russian crisis**, because banks had limited direct exposure to Russia. A substantial strengthening of prudential regulations and supervision, most recently with the decision in December 1998 to implement the Core Principles for effective banking supervision, has helped bolster the banking system. Moreover, the banking system had undergone a major shake-out since the banking crisis, and foreign investors now play an important role in the sector. All banks reported profits in 1998, and have reportedly been meeting prudential regulations since October 1998. Worries remain, however, pertaining to credit quality following the Russian crisis, reliance on short-term foreign borrowing, and market concentration.[12]

22. **The authorities have continued their determined effort to join international economic and security organizations**. Following the approval of the *Accession Partnership between Lithuania and the EU* by the European Commission in March 1998, the authorities have made considerable progress in meeting the Copenhagen criteria on a functioning market economy and the capacity to cope with competitive pressure and market forces. According to the EU, further progress is needed in enterprise and bank privatization, land reform, and bankruptcy procedures. The authorities are determined to join *NATO* and have started to upgrade its military defense to that end. *WTO accession* talks continue, although difficult issues relating to domestic support and protection for agriculture remain; the authorities hope that WTO accession could take place by mid-2000.

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[11]See World Bank (1998): "*Lithuania: An Opportunity for Economic Success.*"

[12]Box 4 and the Background Paper provide overviews of the banking sector and prudential supervision.

Box 4: Banking Sector Issues

The Lithuanian banking system consists of ten commercial banks (including two large state-owned banks), two branches of foreign banks, one subsidiary of a foreign bank (licensed in May 1999), four representative offices of foreign banks, and two specialized banks. The BOL supervises banks as well as 29 credit unions (whose assets account for less than 0.1 percent of the total assets of the banking system). The two state-controlled banks account for approximately 45 percent of total bank assets, while the two largest private banks account for 40 percent.

The capital adequacy requirement is 10 percent of risk-weighted assets, using EU and BIS methodology since January 1997. The definition of Tier II capital was clarified in 1999. Capital requirements for market risks are expected to be implemented by the end of 2000.

Nonperforming loans and specific provisions have declined significantly since 1997 (see table below). This, in part, is caused by the closure of the State Commercial Bank in March 1998, the transfer of bad loans of the Agricultural Bank to the asset management company, the BOL's review of banks' credit policies, and banks' obligation to write-off loans classified as losses for two quarters (effective January 1, 1999). Loans to a single borrower or group of connected borrowers are limited to 25 percent of own funds (no cumulative limit for all large exposures exist).

Exposure to the property sector is relatively limited, since only 11.5 percent of all loans are collateralized by real estate (March 1999). Banks are subject to supervision on a consolidated basis.

Direct exposure to Russia is reportedly limited. Banks have made additional specific provisions of about LTL 54 million, or about 1 percent of total loans, due to the Russian crisis.

Foreign exchange exposure is passed on to borrowers or hedged (although foreign exchange loans to domestic borrowers could entail credit risk). In early 1998, banks moved from a positive net foreign assets position to a negative net foreign assets position.

Off-balance sheet liabilities increased by 26 percent during 1998 and amounted to about 13 percent of total commercial bank liabilities at the end of 1998. Foreign exchange sale contracts are to a large extent matched by purchase contracts, thus limiting the net open position.

The liquidity requirement is 30 percent of liabilities maturing within one month, but methodology strengthened, effective July 1, 1999. Commercial banks' portfolios of treasury bills account for about 11 percent of their assets.

All locally incorporated banks reported **profits** in 1998 after several years of losses in the aftermath of the banking crisis in 1995–96, although external auditors of some banks recommended additional provisions for bad loans. Profits before tax of locally incorporated banks accounted for 0.8 percent of total assets in 1998, compared to -0.7 percent in 1997 (0.2 percent excluding the State Commercial Bank). The spreads between lending and deposit interest rates have since mid-1998 increased from about 5½-7 percent to 7-8 percent (1-3 month maturities).

Commercial Banking Sector Indicators, 1996–March 1999

	1996	1997	1998	March 1999
		(Percent)		
Loans (annual growth rate)	-5.5	20.8	24.1	28.5
Deposits (annual growth rate)	9.8	45.3	11.0	14.5
Loan to deposit ratio (end of period)	83.1	69.1	77.2	80.7
Loan to deposit ratio in foreign exchange (end of period)	67.2	70.6	103.0	113.1
Capital adequacy (end of period)	10.5	10.8	23.8	22.7
State-owned banks	...	0.3	19.6	18.3
Privately owned banks	...	18.0	26.0	25.1
Leverage ratio (end of period)	6.6	5.9	14.9	14.8
Nonperforming loans (percent of loans)	32.1	28.3	12.9	12.2
Specific provisions (percent of loans)	...	18.5	5.7	5.6
Net foreign assets (percent of total assets)	5.4	3.4	-4.4	-3.6
Aggregate open position in foreign exchange (percent of capital)	...	-33.4	-3.8	3.0
Liquidity ratio	...	65.5	58.7	57.2

Source: Bank of Lithuania.

III. Report on the Discussions

23. The Article IV consultation discussions continued after the new government had assumed office, and took place against the background of lingering effects of the Russian crisis on economic activity and the external position. The discussions centered on the strategy to maintain confidence in the currency board, reduce the current account deficit, and reinvigorate structural reforms, with the ultimate goal of returning to sustainable high growth.

A. Macroeconomic Policies

24. **The discussions on macroeconomic policies focused on the authorities' decision to keep the currency board in place at the present exchange rate, and its fiscal policy implications**. The authorities recognized the need to reduce the current account deficit, and explained that their strategy would rely on fiscal adjustment and export promotion measures. The staff representatives supported the emphasis on fiscal policy, noting that since Lithuania is a small open economy, fiscal policy should be targeted at external adjustment rather than countercyclical objectives.

The currency board and external competitiveness

25. **Because the international environment remains unsettled, the authorities are not currently considering an exit from the currency board**. Future exchange rate and monetary policy will be laid out in a new Monetary Policy Program, to be drawn up in late 1999 (the existing Program covers 1997-99 and contains the exit strategy for the currency board). In the meantime, the authorities will seek to reduce the fiscal and current account deficits and prepare for an independent monetary policy (through legal changes to safeguard the BOL's autonomy and the development of monetary instruments). This would help underpin the currency board, and also improve the prospects that an exit would be orderly, should the new Program envisage such a step. Meanwhile, the BOL plans to withdraw liquidity associated with the use of privatization proceeds, through deposit auctions and possibly central bank securities. The staff supported the authorities' decision to maintain the currency board so as to reduce the possibility of speculative pressures on the currency and to underpin fiscal discipline, as well as the intention to neutralize the liquidity impact of the use of privatization proceeds.

26. **While keeping the currency board in place, the BOL envisages a switch to a euro-U.S. dollar basket, before changing to a euro peg**. The BOL sees an interim basket arrangement as justified by the pattern of external trade, external debt, and invoicing, as well as the recent appreciation of the litas vis-á-vis the euro. The BOL will monitor the situation, and expects to make a decision concerning the re-pegging in late 1999 (six months' public notice would be given before any change). The staff warned that such a gradual approach would require several steps, including an early change of the Litas Stability Law, which would test credibility, and that a basket peg would lack the transparency of one-currency peg. The

staff stressed that a change in the peg would not be advisable now, because announcement of a switch (and the necessary legislative period) could lead to speculative pressures, although it agreed that the dollar peg had not been helpful recently.Moreover, an eventual direct switch to a euro peg would be preferable.[13]

27. **Review of a range of indicators suggests that external competitiveness remains adequate**. The authorities did not consider competitiveness a problem overall, although they expressed concern that the recent appreciation of the litas vis-á-vis the euro had hurt some export sectors. The mission agreed that the litas is not clearly overvalued, although there is little room for real appreciation or wage increases that are not related to productivity growth (Box 5).[14] The macroeconomic scenario presented below assumes that external adjustment will be facilitated by fiscal adjustment, and structural reforms that enhance productivity and competitiveness. However, structural reforms may fail to deliver the projected increase in productivity, or wage growth could outstrip productivity growth. In that event, achieving the necessary external adjustment may require even stronger fiscal retrenchment over the medium term.

28. **In the period ahead, exchange rate and balance of payments developments will need to be kept under close review**. On the positive side, the litas is underpinned by prospective large FDI inflows and adequate international reserves in relation to reserve money, short-term external debt, and external debt service. Also, recent external and financial vulnerability indicators show some improvement, and the currency board has again shown resilience under duress. Nevertheless, the current account deficit is projected to remain large in the next few years, and Lithuania would need to weather a rapid increase in external debt service (before it declines after 2002). The BOL stressed that if external pressures were to emerge, it would take monetary action as needed.

Fiscal policy

29. **The authorities recognized that fiscal policy will need to be the central instrument for reducing the current account deficit in the near term**. The government was preparing a revised budget for 1999, in light of lower-than-budgeted revenue. For the revised budget, different options for cutting current expenditure (of up to 1 percent of annual GDP) had been developed, and investment spending could be reduced by postponing projects not already under way (involving expenditure savings of up to ¼ percent of GDP). The government also was reviewing the scope for decreasing net lending. However, presentation to Seimas of the revised 1999 budget was postponed to September, in order to allow a fuller assessment of

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[13]Analytical work by Fund staff suggests that the euro is depreciated against the U.S. dollar beyond the medium-term equilibrium level; a switch to a euro peg now could therefore hurt competitiveness in the future.

[14]The Background Paper provides a further discussion of external competitiveness.

Box 5. Lithuania: External Competitiveness Indicators

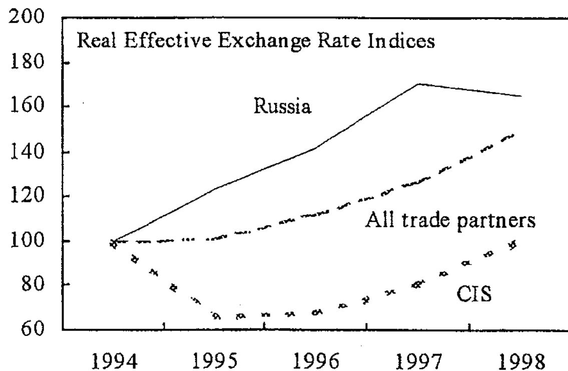
A review of a range of competitiveness indicators suggests that the real exchange rate and the U. S. dollar wage have nearly converged toward their (appreciating) equilibrium levels. Consequently, there is little room for additional real appreciation and real wage increases that are not related to improvements in fundamentals such as productivity increases.

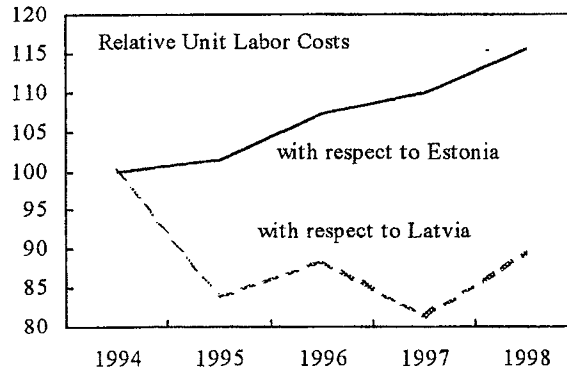
REERs. Since December 1994, the Litas has been steadily appreciating in real effective terms (CPI- based) with a cumulative real appreciation of 63 percent to April 1999 with respect to all trading partners (Figure below). However, the large appreciation is not prima facie evidence that the Litas has become overvalued. First, empirical evidence suggests that there was an initial undervaluation resulting from the depreciation in the first stage of transition. Second, relative productivity gains in the tradable sector (the Balassa-Samuelson effect) imply that the equilibrium real exchange rate (CPI-based) would appreciate. At the same time, the recent narrowing in the inflation differential suggests that the convergence between the (appreciating) equilibrium real rate and the actual real rate may be nearing completion.

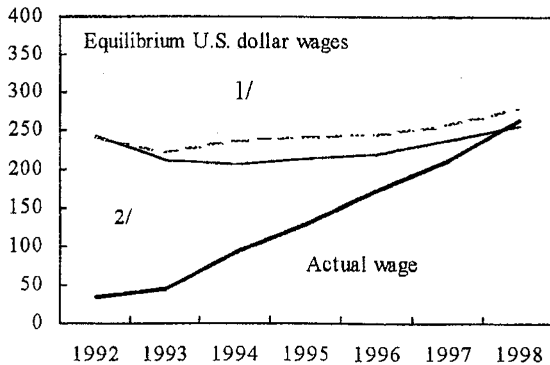
RULCs. Relative unit labor costs suggest a loss of competitiveness with respect to Estonia and a gain vis-à-vis Latvia between 1994 and 1998. The RULC may have declined since late 1998, reflecting the lower growth in Lithuanian wages following the Russian crisis.

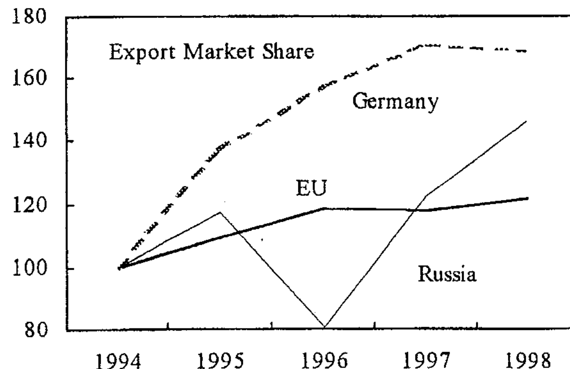
Equilibrium U.S. dollar wages. Estimates of the equilibrium dollar wage, based on a set of fundamentals (see Krajnyák, K. and J. Zettelmeyer, 1998, "Competitiveness in Transition Economies: What Scope for Real Appreciation," *Staff Papers*, 45(2), 309–62), yields a ratio of the actual to the equilibrium dollar wage ranging from 94 percent (when GDP is normalized by employment) to 104 percent (when GDP is normalized by labor force) in 1998.

Export performance. *Export market shares* indicate that: (i) Lithuania has increased its share in the EU, Russian, and German markets since 1994; and (ii) the EU market share increased in the last two quarters of 1998, which may indicate some reorientation of Lithuanian exports from the Russian market; this increase in the EU share did not come from an increase in the German market, suggesting further penetration into the markets of other EU countries. Lithuania's *recorded exports* fell by 5½ percent in U.S. dollar terms in 1998. When interpreting this figure, it should be kept in mind that: (i) the fall masks a decline in CIS exports of 26 percent and an increase in EU exports of 12 percent; (ii) excluding reexports, exports fell only by ½ percent in 1998; and (iii) undervaluation of exports to Russia is believed by the authorities to have increased in 1998.









1/ Equilibrium wage normalized by employment.
2/ Equilibrium wage normalized by labor force.

fiscal performance through June and a more thorough formulation of the expenditure cuts. In the meantime, the government intended to rely on expenditure sequestration and strengthened tax administration, including tax arrears collection. While welcoming the government's intention to reduce the fiscal deficit, the staff noted that the budget plans were based on relatively high real GDP growth in 1999 (of 4 percent) and that the fiscal deficit was likely to be at least 6 percent of GDP before new measures.[15] Also, the staff warned against basing spending plans on expectations of major short-term revenue gains from tax administration measures. It was also pointed out that with new measures of 1½ percentage points of annual GDP, the fiscal deficit could be kept at 0-1 percent of annual GDP in the second half of 1999, or 4½–5 percent of GDP for the year as a whole.[16] This should help contain the current account deficit as private domestic demand recovers, and reduce the annual current account deficit below 11 percent of GDP.[17] To this end, the staff urged the government to identify additional expenditure cuts.[18] Also, the government should not roll over loans to the oil-sector complex when they fall due in July (the authorities explained that the repayment would depend on the agreement on the privatization of the oil-sector complex).

30. **The 2000 budget will be geared towards continuing the current account adjustment**, and will be presented to Seimas after the revised 1999 budget. The authorities indicated that the budget would aim for financial balance (excluding use of privatization proceeds and net lending). To this end, the company income tax will not be eliminated in 2000, as planned by the previous government (although the rate will be reduced from 29 percent to 24 percent).[19] Also, the government intends to implement a prudent public sector wage policy (looking further ahead, this policy would need to be supplemented by a rationalization of the government structure and civil service reform). Taking into account plans for further savings restitution of LTL 650 million (1⅓ percent of GDP) and net lending, a balanced financial account would imply a fiscal deficit upwards of 2 percent of GDP. The staff recommended that the fiscal effort in 2000 focus on current spending restraint—in particular as regards the use of privatization proceeds, which had provided the basis for the jump in current

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[15]This projection assumes that government loans to the oil sector equivalent to 1¼ percent of GDP will be repaid when they fall due in July.

[16]Since the large fiscal deficit so far in 1999 includes the full amount of SRP payments to be made this year (2 percent of annual GDP), the underlying deficit is correspondingly lower.

[17]The rapidly changing macroeconomic environment makes it difficult to assess with precision the effect of fiscal policy on the current account; a particular uncertainty relates to the extent to which SRP payments will be saved. See section IV and Appendix VI for a discussion of the macroeconomic framework.

[18]A parallel FAD technical assistance mission, with World Bank participation, provided advice on expenditure rationalization, with a focus on 1999-2000.

[19]By comparison, the top marginal personal income tax rate is 33 percent.

spending in 1998–99, and public sector wages—more than on tax measures and cuts in investment spending, with the objective of reducing the fiscal deficit to 0-1 percent of GDP and the current account deficit below 10 percent of GDP.

31. **Beyond 2000, the government will need to maintain fiscal restraint in the face of increasing spending pressures**. Such pressures will arise from accession to the EU and NATO, an aging population, structural unemployment, and energy-sector reform.[20] This makes it all the more important to achieve major fiscal adjustment earlier, and move ahead to restructure the energy and agricultural sectors to underpin budget adjustment.

32. **Fiscal adjustment is being supported by administrative reforms relating to the use of privatization proceeds, budgetary control, and tax administration**. The availability of large privatization proceeds had undermined fiscal restraint since mid-1998, and questions had arisen about the transparency of such spending (which are within the government's purview). The mission proposed that, as part of the fiscal consolidation strategy and to improve transparency, the government set aside privatization proceeds in a fiscal reserve fund held abroad, with clear guidelines for utilization (for instance, that the fund could be drawn upon only in emergencies, for pension reform, or for debt retirement). The authorities agreed in principle with this proposal, but did not believe that the build-up of such a fund would be feasible in the near term, given the need to rely on privatization proceeds for budgetary financing. They explained that the new Budget Law (see below) will make the spending of privatization proceeds subject to Seimas approval.

33. **A new Budget Law has been prepared for submission to Seimas** that: (i) calls for the incorporation of extra budgetary funds—including the Privatization Fund, but excluding the Health Insurance Fund and SoDra—in the budget by 2002; (ii) sets limits on line ministries' end-year spending and includes carry-over provisions, to avoid the end-year spending surge that has complicated budget management in recent years; and (iii) provides for a three-year rolling budget framework. A new **Treasury Law** was approved in March 1999, inter alia providing the basis for a Single Treasury Account and requiring Seimas approval for the establishment of new extra-budgetary funds. To further improve **tax administration**, the State Tax Inspectorate is developing standard guidelines for tax collectors to reduce arbitrary tax enforcement and upgrading computer systems, and an anti-smuggling committee has been established.

B. Structural Policies

34. **The structural reform agenda represents a continued effort towards establishing a fully functioning market economy**, with many specific initiatives guided by EU and WTO membership aspirations. The authorities and the staff agreed that structural policies should be geared toward underpinning the budget, promoting growth in productivity and income, and

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[20]The Background Paper provides a discussion of medium-term fiscal issues.

enhancing nongovernment saving. In this sense, structural reforms would have a central role in achieving the necessary current account adjustment over the medium term.[21]

35. **Pension reform should help address the social insurance fund's financial problems and promote household saving**. The Ministry of Social Security has developed a plan to strengthen SoDra's finances. In the short term, the plan relies on tightening revenue collection, broadening the payroll tax base, and limiting the increase in pensions. The passage of a new Social Insurance Law in early 1999 was a first step towards addressing SoDra's cash flow problem. The longer-term sustainability questions associated with the PAYG pension system and an aging population structure would be addressed by increasing the pension eligibility age and changing the indexation mechanism to keep pensions within available resources. Reform of the public system would be supplemented by the introduction of a three-tier pension system, including private pension schemes; a new framework law for private pensions was approved by Seimas in June.

36. **Acceleration of privatization should provide a welcome boost to restructuring and growth, and should also help enhance corporate saving**. A number of large enterprises have been put on the cash privatization list, and the new government reaffirmed its commitment to move ahead with the divestiture of these companies. The government representatives stressed that, in order to reap the benefits of privatization, sales would be conducted in an open and transparent manner (the Privatization Law permits a number of different sales methods, including public auctions and sale through direct negotiation).

37. **Hardening of the budget constraints faced by enterprises is needed to promote restructuring and raise corporate saving**. In this regard, the government representatives noted that it will be particularly important to scale back explicit and implicit *state support for enterprises*, such as loan guarantees. Concerning *market entry*, the government intends to streamline regulations and licensing requirements, in consultation with the local business community, to facilitate enterprise start-ups. The government also is working to bring into operation the Competition Council, which is envisaged under the new Competition Law as an independent agency. With regard to *market exit*, the Lithuanian representatives explained that a new Bankruptcy Law had been submitted to Seimas. The new Law will expedite the completion of bankruptcy cases by setting a maximum time limit of two years for completion of bankruptcy cases, increasing flexibility in pricing, and giving liquidation commissions more autonomy.

38. **Reforms of the energy and agricultural sectors are needed to reorient the economy and support budget adjustment**. In the *energy sector*, the authorities plan to speed up restructuring, improve corporate governance, and strengthen the financial position of

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[21]Lithuania's large current account deficit is associated with a relatively low level of saving in the non-government sector, and an investment level that is generally considered consistent with robust medium-term economic growth.

energy companies. Immediate priorities will be to increase electricity tariffs and give the Energy Pricing Commission an increased role in reviewing and revising energy prices. In *agriculture*, the government program focusses on orienting government support towards private farming and speeding up land reform.

39. **Lithuania's generally liberal trade regime has been key in restoring economic growth, although the government from time to time has resorted to trade measures in support of individual industries**. The temporary trade measures introduced immediately after the Russian crisis—including higher import tariffs and binding minimum import reference prices for certain agricultural products—remain in place and no specific dates have been set for their expiration; also, the government in early 1999 increased the import tariffs on some petroleum products.[22] The Lithuanian representatives explained that trade policy would be guided by the ongoing WTO accession negotiations, and that the binding import reference prices and the higher petroleum import tariffs would be abolished when Lithuania joins WTO. The export promotion strategy would rely primarily on market research and information dissemination among potential investors and in export markets, as well as training; also, the few remaining export tariffs (on hides, raw skins, and lumber) will be abolished by January 1, 2001.

C. Financial Sector Issues

40. **Safeguarding financial sector stability will be important to ensure that the banking system can withstand pressures, and to promote efficient intermediation of saving**. In the area of *prudential supervision*, the BOL's priority is to continue strengthening the supervisory framework, in line with EU requirements and the Core Principles for Effective Banking Supervision. This will inter alia include the adoption of a cumulative limit on all large exposures and the EU's capital adequacy directive. In addition, the BOL is working to ensure that banks make *adequate provisions* for bad loans in the wake of the slowdown in economic growth and higher real interest rates. The BOL sees the need to safeguard *competition* in the banking sector, and has issued regulations to prevent undue concentration and welcomed foreign investors.[23] Concerning financial sector reform, the *privatization of Savings Bank and Agricultural Bank* will move ahead in 1999/2000. *Institutional investors* are being encouraged through pension reform and continued adoption of EU standards for securities transactions.

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[22]Even after these tariff increases, Lithuania receives the most favorable rating (1 on a scale from 1 to 10) on the IMF's trade restrictiveness index.

[23]Foreign investors have invested in commercial banks (including being majority share holders in the two largest private banks), two foreign banks have established branches in Lithuania, and a subsidiary of a foreign bank recently has been licensed.

D. Transparency, Economic Data, and Y2K

41. **The new government recognizes that transparency in economic policies will be critical for market confidence and for public support of its economic policies**. In this regard, it attaches particular importance to avoiding any perception that the privatization process lacks transparency. In line with the policy of openness in economic policy matters, the authorities have decided take part in the pilot project on publication of Article IV consultation reports.

42. **Balance of payments data need to be improved**. The authorities are engaged in an ongoing effort to improve economic data, with the focus recently being on the strengthening of the collection of balance of payments data. They expect that the forthcoming posting of an IMF resident advisor on balance of payments statistics will help in this endeavor.

43. **A number of initiatives have been taken to deal with the Y2K problem**. The government has set up a commission that will shortly complete an inventory of all computer systems in strategic sectors. In the financial sector, banks have been required to comply with an action plan for Y2K readiness, and the BOL's supervision reviews compliance with this plan. The Stock Exchange, the Settlement Center, and the Central Depository all have conducted tests without identifying problems.

IV. Macroeconomic Framework

44. **An up-front fiscal adjustment combined with steadfast structural reform should allow a return to sustained economic growth**. The staff's medium-term macroeconomic framework—based on an up-front fiscal adjustment, reinforced structural reforms, recovery in export markets, and continued availability of foreign financing—suggests that annual GDP growth, after slowing to about ½ percent in 1999, could recover to 4 percent in 2000 and 5–6 percent annually thereafter (Table 5 and Appendix VI). Inflation could pick up to 2½ percent (12-month rate) during 1999, as prices recover from the initial effects of the Russian crisis, and subsequently remain in the 2–3 percent range. Reducing the fiscal deficit to 4½-5 percent of GDP in 1999 and further to 0-1 percent in 2000 should help reduce the current account deficit below 11 percent of GDP in 1999 and 10 percent in 2000. The staff scenario assumes that recipients of restituted savings would not spend their entire receipts; consequently, an increase in non-government saving also would help the current account adjustment in 1999.[24] Thereafter, the main impetus to the external adjustment would come from gradual increases in household saving in response to higher income growth, pension reform, and a more developed financial system, and in corporate saving as a result of privatization and policies to harden budget constraints. The debt-to-GDP and debt-service-to-

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[24]The authorities have put in place a range of measures that they believe will discourage spending of restituted savings (see Box 2).

exports ratios would peak at 38 percent and 27 percent, respectively, in 2002, before declining gradually in the following years.

45. **There are potential downside risks to this macroeconomic scenario**: *non-government saving* may fail to recover; *export growth* may fall short of projections; and *access to international capital markets and FDI* may be lower. There is the risk that adverse developments could precipitate financial distress, force a sudden current account adjustment, and disrupt growth. Also, weak follow-through on economic policies—e.g., less ambitious fiscal adjustment—could result in adverse external trends over the medium term. Appendix VI explores the implications for external indicators of such developments.

V. Staff Appraisal

46. **Lithuania will need to take strong actions to return to sustained economic growth**. Lithuania has made great progress in economic stabilization and market reform since independence was regained. The challenge facing the authorities in the period ahead will be to continue this progress and protect confidence in the litas. The first item on the agenda will be to bring fiscal policy firmly under control, supplemented by a reinvigoration of structural reforms.

47. **Maintaining the currency board should help protect financial stability**. For this to happen, however, the authorities will need to move ahead to reduce the current account deficit and the reliance on external financing. In the meantime, an unequivocal commitment by the authorities to the currency board at the present peg and exchange rate level should help minimize the risk of a speculative attack on the litas. The authorities will need to monitor closely developments in the balance of payments and indicators of external competitiveness, and stand ready to take action if balance of payments pressures were to emerge. The authorities' commitment to transparency in economic policies should help bolster market confidence, and should be supported by reinforced efforts to improve economic data.

48. **A reorientation of fiscal policy will need to be the cornerstone of the external adjustment strategy in the near term**. To this end, the government should immediately start implementing the identified expenditure reductions for 1999. The 2000 budget will need to be oriented towards continuing the external adjustment, with the focus on further restraint on current expenditure. No tax measures that could undermine fiscal adjustment should be contemplated, and the staff welcomes the retention of the company income tax (regrettably at a reduced rate). The staff would encourage the authorities to establish a fund for investment of privatization proceeds, with clear guidelines for utilization, to help strengthen transparency and fiscal adjustment; in particular, privatization proceeds should not be used to finance current spending. Public sector wage restraint and civil service reform should also help budgetary adjustment, and should send an important signal to the private sector.

49. **To underpin budgetary and external adjustment, it will be important to strengthen budget procedures, accelerate pension reform, and restructure the energy and agricultural sectors**. High priority should be given to adoption of the new Budget Law, better payroll tax collection combined with pension reform, price increases and cost cuts in the energy sector, and scaling back of government support for agriculture.

50. **To promote restructuring and growth, market exit and entry must be facilitated**. The increased extension of government support to agriculture and other sectors, in the form of outright budget support and import protection, was an inappropriate response to the Russian crisis, as enterprises need to be further exposed to market pressures. In this connection, the revival of privatization, the new Competition Law, and the revision of the Bankruptcy Law are welcome. Also, the government's planned scaling back of support of enterprises and simplification of regulations and licensing requirements should be expedited. Import protection for specific sectors—such as agriculture and the oil industry—should be scaled back.

51. **The BOL's continued vigilance in banking supervision is appropriate**. While a sounder banking system has emerged after the banking crisis of 1995/96 and the limited direct exposure to Russia so far has helped weather recent developments, the potential secondary effects through domestic borrowers exposed to the CIS underscores that vigilant prudential supervision is called for also in the period ahead. In that regard, the staff supports the BOL's efforts to strengthen prudential supervision, including the decision to implement the Core Principles for Effective Banking Supervision.

52. **The macroeconomic outlook is favorable, but is not without risks**. Fiscal adjustment and market reforms should help Lithuania return to high sustained growth and ensure a viable external position. Even so, adverse developments could jeopardize orderly external adjustment and lead to lower economic growth. The main external risk factors in this regard are the possibility of lower export growth, reduced access to international capital markets, and lower FDI. To limit the destabilizing effects of such developments, fiscal policy must be restrained. If Lithuania were faced with adverse external developments, a further strengthening of fiscal policy and reinforced structural reforms would be called for.

53. **It is proposed that Lithuania remains on the standard 12-month consultation cycle**. The authorities' decision to participate in the pilot project for publication of Article IV consultation staff reports is welcome. Given the uncertainties that are bound to characterize the period ahead, Lithuania could be well served by a Fund-supported program.

Table 1. Lithuania: Key Economic and Financial Indicators, 1995-99

	1995	1996	1997	1998	1999 Act/Est. 1/
	(Percentage changes from previous period)				
Real GDP	3.3	4.7	7.3	5.1	-5.7
Consumer prices					
Period average	39.5	24.7	8.8	5.1	2.4
End of period	35.5	13.1	8.4	2.4	0.6
Broad money	29.0	-3.5	34.1	14.5	20.1
Reserve money	35.0	2.2	32.4	28.8	15.9
Credit to private sector	23.0	-4.4	18.9	16.9	19.0
Currency in circulation	42.9	-0.4	33.5	10.4	13.7
Velocity of broad money	4.8	6.2	6.1	5.4	4.4
Money multiplier 2/	2.3	2.2	2.2	2.0	2.2
Deposit interest rate 3/	17.6	10.6	6.2	7.1	7.3
Lending interest rate 3/	26.2	14.7	12.2	16.7	15.9
	(Percent of GDP)				
Gross national saving	14.5	15.3	16.3	13.4	...
General government	2.4	0.2	2.0	-1.0	...
Non-government	12.1	15.2	14.4	14.4	...
Gross investment	24.7	24.5	26.5	25.5	...
General government	3.8	2.7	2.7	2.7	...
Non-government	20.9	21.8	23.9	22.8	...
General government financial balance 4/	-2.6	-2.5	-0.8	-4.3	-7.0
General government net lending	1.9	2.0	1.0	1.5	-0.3
Consolidated general government fiscal balance 4/	-4.5	-4.5	-1.8	-5.8	-6.7
External current account (incl. transfer)	-10.2	-9.1	-10.2	-12.1	-9.6
External debt 5/	13.7	21.3	25.7	26.3	...
Debt service (in percent of exports of goods and services)	2.5	8.1	10.6	18.4	...
	(In millions of litai at current prices)				
Gross domestic product	24,103	31,569	38,340	42,768	8,997
	(In millions of U.S. dollars)				
Gross domestic product	6,026	7,892	9,585	10,692	2,249
Current account (inc. transfers)	-614	-722	-981	-1,298	-216

Sources: Department of Statistics, Bank of Lithuania; and Fund staff estimates and projections.

1/ National accounts, budget, and current account data are preliminary, actuals are for the first quarter; monetary data are actuals for May, and inflation data are actuals for June.

2/ Level in final quarter of calendar year.

3/ In percent; weighted average of rates at commercial banks in December; 1-3 months' maturity.

4/ Includes discrepancy between above and below the line estimates of the financial balance and balances of budgetary organizations not recorded in the above the line numbers. Also includes savings restitution payments.

5/ Includes public, publicly guaranteed, and private external debt.

Table 2. Lithuania: Balance of Payments, 1996-2004

(US$ millions)

	1996	1997	1998		1998 1/	1999	2000	2001	2002	2003	2004
			Half 1	Half 2 1/	Year			Projections			
Current account	-722	-981	-521	-777	-1,298	-1,180	-1,096	-1,028	-937	-795	-596
Merchandise trade	-896	-1,147	-644	-874	-1,518	-1,314	-1,181	-1,082	-982	-851	-685
Exports	3,413	4,192	2,110	1,852	3,962	4,001	4,241	4,665	5,225	5,852	6,555
Imports	4,309	5,340	2,754	2,726	5,480	5,316	5,422	5,747	6,207	6,703	7,240
Non-factor services, net	121	134	142	99	241	278	328	395	479	576	688
Credits	798	1,032	535	574	1,109	1,120	1,187	1,306	1,463	1,638	1,835
Debits	677	897	394	475	868	842	859	911	984	1,062	1,147
Factor income, net	-91	-198	-146	-110	-255	-413	-573	-682	-784	-870	-948
Current transfers	144	230	127	108	235	270	330	340	350	350	350
Financial and capital account	651	1,105	547	866	1,412	1,295	1,233	1,185	1,111	984	798
Foreign direct investment, net	152	328	222	699	921	500	550	550	550	550	550
Portfolio investment, net	63	188	10	-63	-53	349	296	339	500	270	378
Private, bonds	-28	157	-11	-94	-105	163	246	312	300	270	150
Public, bonds	74	0	21	31	52	186	50	27	200	0	228
Loans and trade credit, net	477	699	192	208	400	391	330	235	-2	109	-145
Trade credits	8	151	-48	14	-34	0	0	0	0	0	0
Public	229	138	79	55	134	144	-8	122	-119	88	-134
Guaranteed	154	117	46	66	112	61	65	9	-19	-52	-37
Private	86	292	115	73	188	186	273	104	136	72	26
Currency and deposits and other financial flows	-47	-113	122	24	146	50	53	55	58	50	10
Capital transfers	5	4	0	-2	-2	5	5	6	5	5	5
Errors and omissions	60	107	92	223	315	0	0	0	0	0	0
Central bank	-11	-231	-118	-311	-429	-116	-138	-157	-174	-188	-202
Fund financing	20	14	-18	-12	-30	-16	-28	-36	-41	-41	-41
Purchases	45	56	0	0	0	0	0	0	0	0	0
Repurchases	24	42	18	12	30	16	28	36	41	41	41
Reserves (-=increase)	-31	-245	-100	-299	-399	-100	-110	-121	-133	-146	-161
Memorandum items:											
GDP (US$ millions)	7,892	9,585	5,041	5,652	10,692	10,917	11,703	12,704	13,782	14,957	16,278
Gross official reserves (US$ millions)	850	1,063	1,163	1,462	1,462	1,562	1,672	1,793	1,926	2,073	2,234
In months of current year's imports	2.0	2.0	2.2	2.7	2.8	3.0	3.2	3.2	3.2	3.2	3.2
In months of next year's imports	1.6	2.0	2.5	2.6	2.8	3.0	3.0	3.0	3.0	3.0	...
In percent of short-term debt	456	494	506	600	600	575	456	384	323	309	318
In percent of debt service 2/	248	192	...	...	167	137	125	129	106	120	113
In percent of reserve money	136	129	125	137	137	134	131	128	126	124	122
External debt (US$ millions)	1,680	2,462	2,665	2,809	2,809	3,550	4,175	4,749	5,247	5,625	5,859
Debt service (US$ millions)	342	554	...	...	877	1,138	1,343	1,394	1,821	1,720	1,975
Debt service in percent of exports of GNFS	8.1	10.6	...	...	17.3	22.2	24.7	23.3	27.2	23.0	23.5
Export value (change in percent)	26.1	22.8	7.3	-16.8	-5.5	1.0	6.0	10.0	12.0	12.0	12.0
Import value (change in percent)	26.6	23.9	10.4	-4.2	2.6	-3.0	2.0	6.0	8.0	8.0	8.0
					(In percent of GDP)						
Current account balance	-9.1	-10.2	-10.3	-13.8	-12.1	-10.8	-9.4	-8.1	-6.8	-5.3	-3.7
External debt	21.3	25.7	...	...	26.3	32.5	35.7	37.4	38.1	37.6	36.0
Public and publicly guaranteed	11.5	12.0	...	...	13.4	16.7	16.5	16.4	15.6	14.6	13.8
Private	9.8	13.6	...	...	12.9	15.8	19.2	21.0	22.5	23.0	22.2
Short-term external debt (public and private)	2.4	2.2	...	...	2.3	2.5	3.1	3.7	4.3	4.5	4.3
Exports of goods and non-factor services	53.4	54.5	52.5	42.9	47.4	46.9	46.4	47.0	48.5	50.1	51.5
Imports of goods and non-factor services	63.2	65.1	62.5	56.6	59.4	56.4	53.7	52.4	52.2	51.9	51.5
Financial account	8.2	11.5	10.8	15.3	13.2	11.8	10.5	9.3	8.0	6.5	4.9
Medium and long term	8.3	10.5	8.6	16.1	11.9	11.1	9.2	8.1	6.7	5.7	4.6
Foreign direct investment	1.9	3.4	4.4	12.4	8.6	4.6	4.7	4.3	4.0	3.7	3.4

Source: Data provided by the Lithuanian authorities; and staff estimates and projections.

1/ Preliminary actual data.
2/ Debt service falling due, including public and private debt, regardless of original maturity.

Table 3. Lithuania: Summary of Consolidated General Government Operations 1/

	1996	1997	1998	1998	1998	1999	2000
			Est.	1st half	2nd half	Adj. Scen.	Adj. Scen.
			(In millions of Litai)				
Total revenue	9346	12501	14604	6913	7692	14958	16389
Tax revenue	9092	12250	14307	6746	7561	14586	15989
o/w							
Taxes on income and profits 2/	2673	2579	3000	1405	1595	2981	3216
Taxes on companies	587	621	579	289	289	498	490
Taxes on individuals	2087	1958	2422	1116	1306	2483	2726
Payroll tax (social security tax) 2/	2608	4391	5524	2605	2919	5683	6297
Taxes on goods and services	3115	4513	4952	2347	2605	5164	5576
Excises	836	1165	1340	606	734	1389	1496
Value-added tax	2280	3348	3612	1741	1871	3775	4080
Nontax Revenue	254	251	297	167	130	372	400
Expenditure and net lending	10791	13165	16820	7367	9453	17017	16800
Expenditure	10156	12771	16192	7329	8863	17036	17000
Current expenditure	9294	11752	14590	6920	7671	15043	15250
Wages and Salaries 3/	3018	3333	4239	2058	2182	...	...
Goods and Services 3/	2434	3730	5069	2359	2709	...	...
Savings restitution	0	0	443	0	443	904	650
Capital Expenditures	862	1019	1159	409	750	1088	1100
Discrepancy	-22	32	270	-14	284	-28	0
Financial balance	-789	-302	-1858	-402	-1456	-2050	-611
Net lending	635	395	628	38	590	-19	-200
Lending	669	626	925	214	711	567	...
Repayments (-)	-34	-231	-297	-176	-121	-586	...
Fiscal balance (deficit (-))	-1424	-697	-2487	-441	-2046	-2031	-411
Financing	1424	697	2487	441	2046	2031	411
Net domestic	354	-17	-315	64	-379	-361	-908
Net foreign	1038	610	535	315	220	1488	-31
Gross privatization receipts	32	104	2267	62	2205	904	1350
			(In percent of GDP)				
Total revenue	29.6	32.6	34.1	34.3	34.0	34.3	35.0
Tax revenue	28.8	31.9	33.5	33.5	33.4	33.4	34.2
o/w							
Taxes on income and profits 2/	8.5	6.7	7.0	7.0	7.1	6.8	6.9
Taxes on companies	1.9	1.6	1.4	1.4	1.3	1.1	1.0
Taxes on individuals	6.6	5.1	5.7	5.5	5.8	5.7	5.8
Payroll tax (social security tax) 2/	8.3	11.5	12.9	12.9	12.9	13.0	13.5
Taxes on goods and services	9.9	11.8	11.6	11.6	11.5	11.8	11.9
Excises	2.6	3.0	3.1	3.0	3.2	3.2	3.2
Value-added tax	7.2	8.7	8.4	8.6	8.3	8.6	8.7
Nontax revenue	0.8	0.7	0.7	0.8	0.6	0.9	0.9
Expenditure and net lending	34.2	34.3	39.3	36.5	41.8	39.0	35.9
Expenditure	32.2	33.3	37.9	36.4	39.2	39.0	36.3
Current expenditure	29.4	30.7	34.1	34.3	33.9	34.5	32.6
Wages and Salaries 3/	9.6	8.7	9.9	10.2	9.7	...	...
Goods and Services 3/	7.7	9.7	11.9	11.7	12.0	...	...
Savings restitution	0.0	0.0	1.0	0.0	2.0	2.1	1.4
Capital Expenditures	2.7	2.7	2.7	2.0	3.3	2.5	2.3
Discrepancy	-0.1	0.1	0.6	-0.1	1.3	-0.1	0.0
Financial balance	-2.5	-0.8	-4.3	-2.0	-6.4	-4.7	-1.3
Net lending	2.0	1.0	1.5	0.2	2.6	0.0	-0.4
Fiscal balance (deficit (-))	-4.5	-1.8	-5.8	-2.2	-9.0	-4.7	-0.9
Financing	4.5	1.8	5.8	2.2	9.0	4.7	0.9
Net domestic	1.1	0.0	-0.7	0.3	-1.7	-0.8	-1.9
Net foreign	3.3	1.6	1.3	1.6	1.0	3.4	-0.1
Gross privatization receipts	0.1	0.3	5.3	0.3	9.8	2.1	2.9
Memorandum Items:							
Nominal GDP (in millions of litai)	31,569	38,340	42,768	20,162	22,606	43,666	46,813
Fiscal deficit, including privatization proceeds	-4.4	-1.5	-0.5	-1.9	0.7	-2.6	2.0
Fiscal deficit, excluding Savings Restitution Plan	-4.5	-1.8	-4.8	-2.2	-7.1	-2.6	0.5

Sources: Ministry of Finance, Ministry of Social Security; and Fund staff estimates.

1/ Including the state budget, municipal budgets, Social Insurance Fund and from 1997, the Health Insurance Fund.

2/ From 1997, contributions to the HIF are reclassified from income tax to payroll tax.

3/ From 1997, expenditures of the HIF are reclassified from wages and salaries to goods and services.

Table 4. Summary Monetary Accounts, December 1996-May 1999
(In millions of litai, end of period)

	1996	1997	1998				1999	
			Mar.	Jun.	Sept.	Dec.	Mar.	May
Monetary Authorities								
Net Foreign Assets	2,248	3,171	3,553	3,661	5,094	4,836	4,591	4,487
Gold	248	211	211	211	211	203	203	203
Convertible currencies	1,992	2,952	3,334	3,442	4,876	4,625	4,380	4,276
Nonconvertible currencies	0	0	0	0	0	0	0	0
Other foreign assets	8	8	8	8	8	8	8	8
Net Domestic Assets	251	138	-168	59	-1,454	-575	-788	-477
Net credit to Government	-108	-307	-590	-310	-1,824	-947	-1,129	-861
Credit to banks	142	70	68	51	88	52	67	67
Credit to private sector	10	8	7	7	7	7	7	7
Credit to nonbank financial institutions	3	19	19	19	20	7	6	6
Other items, net	204	348	327	291	255	305	261	303
Reserve Money	2,499	3,309	3,385	3,719	3,640	4,260	3,802	4,010
Currency outside the central bank	1,999	2,726	2,655	2,904	2,722	3,036	2,871	3,121
Deposit money banks' deposits	483	551	699	801	906	1,212	912	878
Reserves in litai	397	390	509	489	546	868	565	539
Required reserves in foreign currency	86	161	190	311	347	344	332	338
Time deposits	...	0	0	0	12	0	16	0
Special deposits	0	0	0	1	0	0	0	0
Private deposits and deposits of nonmonetary financial institutions	17	31	31	14	12	13	19	11
Monetary Survey								
Net Foreign Assets	2,639	3,483	3,296	3,283	4,452	4,292	4,144	3,835
Net Domestic Assets	2,785	3,789	3,845	4,295	3,243	4,035	3,999	4,957
Net claims on government 1/	-522	-80	-401	39	-1,341	-505	-427	-98
Credit to nonfinancial public enterprises	134	149	152	84	230	352	400	481
Credit to private sector	3,506	4,170	4,475	4,717	4,794	4,874	5,238	5,505
Credit to nonbank financial institutions	48	170	216	312	443	470	458	470
Other items, net	-382	-620	-598	-855	-883	-1,155	-1,669	-1,400
Broad Money	5,424	7,272	7,141	7,578	7,695	8,327	8,143	8,792
Currency outside banks	1,899	2,535	2,490	2,726	2,554	2,800	2,663	2,915
Deposits	3,525	4,736	4,651	4,852	5,141	5,527	5,480	5,876
Memorandum items:								
Reserve money (yearly percent change)	2.2	32.4	36.9	30.7	18.0	28.8	12.3	15.9
Broad money (yearly percent change)	-3.5	34.1	28.6	23.5	13.8	14.5	14.0	20.1
Private sector credit (yearly percent change)	-4.4	18.9	26.2	28.5	28.1	16.9	17.0	19.0
Money multiplier	2.2	2.2	2.1	2.0	2.1	2.0	2.1	2.2
Reserve ratio (percent, end of month)	13.7	11.6	15.0	16.5	17.6	21.9	16.6	14.9
Cash-deposit ratio	0.5	0.5	0.5	0.6	0.5	0.5	0.5	0.5
Foreign currency deposits/ litas deposits	0.60	0.48	0.54	0.56	0.56	0.57	0.59	0.60
Quarterly inflation rate (CPI, end of period)	2.2	1.9	1.9	0.6	-0.8	0.7	0.8	...
Average quarterly 3 month T-bill rate	3.0	1.9	2.1	2.5	2.5	3.3	2.6	2.9
Quarterly GDP (millions of litai)	8,667	10,617	9,305	10,857	11,496	11,110	8,936	11,098
Velocity of broad money 2/	6.5	6.1	5.2	5.9	6.0	5.4	4.5	4.4
Currency board cover ratio (in percent)	137	127	124	131	180	144	153	143

Source: Bank of Lithuania

1/ Excludes local government deposits; includes counterpart funds.

2/ On a quarterly basis; the annualized quarterly estimate of GDP divided by the average of end-period broad money in the current quarter and previous quarter.

Table 5. Lithuania: Medium-Term Macroeconomic Framework, 1996-2004

	1996	1997	1998	1999	2000	2001	2002	2003	2004
				Projections					
				(Percentage changes from previous period)					
Real GDP	4.7	7.3	5.1	0.5	4.0	5.5	5.7	5.7	6.0
Consumer prices									
Period average	24.7	8.8	5.1	1.6	2.8	2.8	2.5	2.6	2.3
End of period	13.1	8.4	2.4	2.5	2.8	2.7	2.6	2.4	2.3
				(Percent of GDP)					
Gross national saving	15.3	16.3	13.4	12.7	15.6	16.9	18.2	19.7	21.3
General government	0.2	2.0	-1.0	-2.3	1.0	2.5	2.5	2.5	2.5
Non-government	15.2	14.4	14.4	15.0	14.7	14.4	15.7	17.2	18.8
Gross investment	24.5	26.5	25.5	23.5	25.0	25.0	25.0	25.0	25.0
General government	2.7	2.7	2.7	2.5	2.3	2.5	2.5	2.5	2.5
Non-government	21.8	23.9	22.8	21.0	22.7	22.5	22.5	22.5	22.5
General government financial balance 1/	-2.5	-0.8	-4.3	...	...	...	...	...	...
General government net lending	2.0	1.0	1.5	...	...	...	...	...	...
Consolidated general government fiscal balance 1/	-4.5	-1.8	-5.8	-4.7	-0.9	0.0	0.0	0.0	0.0
External current account balance (incl. transfers)	-9.1	-10.2	-12.1	-10.8	-9.4	-8.1	-6.8	-5.3	-3.7
External debt 2/	21.3	25.7	26.3	32.5	35.7	37.4	38.1	37.6	36.0
Debt service (in percent of GNFS)	8.1	10.6	17.3	22.2	24.7	23.3	27.2	23.0	23.5
				(In millions of litai at current prices)					
Gross domestic product	31,569	38,340	42,768	43,666	46,813	50,817	55,127	59,827	65,113
				(In millions of U.S. dollars)					
Gross domestic product	7,892	9,585	10,692	10,916	11,703	12,704	13,782	14,957	16,278
Current account (incl. transfers)	-722	-981	-1,298	-1,180	-1,096	-1,028	-937	-795	-596

Sources: Department of Statistics, Bank of Lithuania, and Fund staff estimates and projections.

1/ Includes discrepancy between above and below the line estimates of the financial balance and balances of budgetary organizations not recorded in the above the line numbers. Also includes savings restitution payments.
2/ Includes public, publicly guaranteed, and private external debt.

LITHUANIA: FUND RELATIONS

(As of May 31, 1999)

I. Membership Status: Joined 4/29/92; Article VIII

II. General Resources Account:	**SDR Million**	**% Quota**
Quota	144.20	100.0
Fund holdings of currency	317.98	220.5
Reserve position in Fund	0.02	--

III. SDR Department:	**SDR Million**	**% Allocation**
Holdings	2.14	N/A

IV. Outstanding Purchases and Loans:	**SDR Million**	**% Quota**
Extended arrangements	132.83	92.1
Systemic Transformation	40.97	28.4

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
EFF	10/24/94	10/23/97	134.55	134.55
Stand-by	10/22/93	10/24/94	25.88	5.18
Stand-by	10/21/92	9/20/93	56.93	56.93

VI. Projected Obligations to Fund (SDR Million; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
	5/31/99	1999	2000	2001	2002	2003
Principal	--	6.0	20.7	26.7	31.1	31.1
Charges/Interest	--	3.4	6.4	5.5	4.4	3.2
Total	--	9.4	27.1	32.2	35.5	34.3

VII. Exchange Arrangements:

The currency of Lithuania is the litas. Since April 1, 1994, the litas has been pegged to the U.S. dollar at LTL 4 per U.S. dollar under a currency board arrangement.

VIII. Resident Representative:

The senior resident representative of the Fund in Lithuania is Mr. Adalbert Knöbl, who took up his post in October 1997.

IX. Consultation Cycle:

Lithuania is on the 12-month consultation cycle.

LITHUANIA: TECHNICAL ASSISTANCE FROM THE FUND, 1997-99

Department	Issue	Action	Date	Counterpart
FAD	Treasury operations	Mr. Ramachandran	Feb/Mar. 1997	Ministry of Finance
FAD	Treasury operations	Mr. Ramachandran	Jun. 1997	Ministry of Finance
FAD	Treasury operations	Mr. Ramachandran	Aug/Sep. 1997	Ministry of Finance
STA	Balance of payments	Mr. Allen	Aug/Sep. 1997	Department of Statistics
FAD	Treasury operations	Mr. Ramachandran	Nov/Dec. 1997	Ministry of Finance
MAE	Monetary policy and banking supervision	Mission	Dec. 1997	Bank of Lithuania
STA	National accounts and balance of payments	Mr. Gschwindt de Gyor	Dec. 1996	Department of Statistics
FAD	Treasury operations	Mr. Ramachandran	Jan. and April 1998	Ministry of Finance
STA	Multipurpose	Mr. Allen	1997-98	Department of Statistics, Bank of Lithuania, and Ministry of Finance
STA	Balance of payments	Mr. Gschwindt de Gyor	April 1999	Department of Statistics and Bank of Lithuania
FAD	Expenditure policy	Mission	Jun/Jul 99	Ministry of Finance
MAE	Monetary policy	Mr. Ketterer	Resident Advisor, Starting May 1997	Bank of Lithuania

LITHUANIA: WORLD BANK RELATIONS

1. Lithuania joined the World Bank in July 1992. Since then, the Bank's assistance to Lithuania has concentrated on reforms in key areas such as maintaining macroeconomic stabilization to build and maintain investor confidence, reducing government involvement in business activities, and enforcing the basic legal tenets necessary for private activity. Moreover, the Bank is working with the government to strengthen key financial institutions to facilitate the appropriate provision of credit and movement of capital, as well as assisting in reorienting the social safety net, public services, infrastructure, and the energy sector to the needs of a market economy.

2. The table below provides a summary of IBRD loans as of end-May 1999. It includes 12 projects with commitments totaling US$293 million equivalent and disbursements on all Bank projects in Lithuania amounting to US$190 million. Preparation of other operations is proceeding in the areas of infrastructure, health and municipal services.

3. IFC has approved three projects in Lithuania so far: (a) financing of the expansion/ modernization of a textile mill with German sponsors; (b) a line of credit to support SMEs; and (c) an equity investment in a venture capital fund supporting medium-sized companies in the Baltic States. IFC has also conducted a series of technical assistance projects ranging from advice on securities markets and leasing regulations to review of various aspects of projects which IFC has been considering for financing.

4. Lithuania is a member of MIGA, which has so far not issued any guarantees, but has four applications pending. government representatives have participated in MIGA-sponsored meetings on investment promotion, and Lithuania is an active user of MIGA's Internet-based information dissemination facilities. FIAS has just started a study of administrative barriers to investment.

5. The first World Bank Country Economic Memorandum (CEM) was published in April 1993. A Public Expenditure Review was conducted in 1993/94 and was the basis for a donors meeting on public investments in May 1995. The Bank also has prepared an informal enterprise and financial sector study, a private sector assessment, a comprehensive energy sector review, a study of nuclear energy alternatives commissioned by the G-7, an agricultural review, a municipal finance study, a social insurance/social policy note, and an informal note on transport. In 1998, the Bank completed a multi-sectoral collection of policy notes, and a Country Assistance Strategy (CAS) for 1999–2001, which were discussed by the Board on May 11, 1999. Work has been completed on a Macro Financial Vulnerability Study and started on a Country Economic Memorandum that will focus on the challenges Lithuania will face on its path toward joining the European Union.

World Bank Loans Approved by the Board

(As of end-May 1999; in millions of U.S. dollars)

	Commitments	Disbursements
Rehabilitation Loan 1/ (effective October 1992)	60.0	58.8
SAL (effective October 1996) 2/	80.0	80.0
Power Rehabilitation and Restructuring (effective November 1995)	26.4	4.5
Environment (Klaipeda) (effective May 1995)	7.0	2.4
EFSAL (effective December 1995)	25.0	20.9
Environment (Siauliai) (effective December 1996)	6.2	2.2
Agricultural Development Project (effective August 1996)	30.0	2.8
Klaipeda Geothermal (effective October 1996)	5.9	0.3
Energy/Housing Pilot (effective November 1996)	10.0	1.9
Highway Project (effective September 1996)	19.0	14.5
Social Policy (effective January 1998)	3.7	1.8
Municipal Development (not yet effective)	20.1	0.4
Total	293.3	190.5

Source: The World Bank.
1/ Loan closed in December 1995; US$1.2 million canceled.
2/ Loan closed in June 1998.

LITHUANIA: STATUS OF STATISTICAL DATABASE

1. Lithuania has made good progress in establishing a macroeconomic database. Official data for consumer prices, public finance, and monetary developments are of sufficiently good quality to support economic analysis. However, often large revisions of national accounts and balance of payments tend to complicate the ongoing analysis of economic developments.

2. In general, the data are available on a timely basis, and the authorities have given the staff ready access to all available data (see the attached Data Matrix). An IFS page for Lithuania was introduced in December 1995. In May 1996, the Lithuanian authorities subscribed to the Special Data Dissemination Standard, and its metadata have been posted on the Fund's Dissemination Standards Bulletin Board (DSBB) on the Internet since April 1997. A significant amount of information is now available on the Internet national website (see section on Publications of Statistics, below).

National accounts

3. National accounts at current and constant prices are compiled quarterly by the DOS. Revised estimates were prepared with technical assistance from the World Bank and were published on March 30, 1998. The revised estimates attempt to address the main problem areas: the size of the hidden economy and the extent to which present estimates adequately account for it, and estimates of the GDP deflator. These revisions also correct for conceptual and computational errors existing in the series for the years 1990–96. Two types of corrections were made to the base-line national accounts data processed by the DOS. The first was in respect of under-reporting by firms officially registered with the DOS. The second correction concerned firms and individuals not in the official register and which could thus be assumed to be "hidden." The adjustment for under-reporting was obtained by comparing the value of reported production with employment indicators from social security records and other sources. Corrections for firms not presently in the DOS register were made on an ad-hoc basis and were restricted to output generated in industry and retail trade. With regard to the GDP deflator, the DOS does not publish investment or tradeable goods price indices, although work is underway to prepare estimates of real GDP by expenditure, along with estimates of export and import prices. The constant price estimates are mainly compiled using production volume indicators. Analysis of the implicit GDP deflator in light of plausible price estimates derived from expenditure data and the consumer price index cast some doubts on the accuracy of the GDP deflator.

Price data

4. The CPI was first compiled in May 1992. Revisions and improvements in its compilation and several recalculations updating its weights have taken place since then, with technical assistance from the Fund. New weights have been introduced in January 1997 and the new consumption bundle, thanks to experience gained through the consumption survey,

better reflect the expenditure pattern in Lithuania. In January 1999, the weights were revised based on the 1997 Household Expenditure Survey and a harmonized CPI prepared under an EU pilot project. The monthly CPI is available in the second week of the following month. Since January 1996 the producer price index is calculated according to the Laspeyres formula. Data on investment or tradable goods price indices are not yet available.

Public finance

5. Data on the general government budget execution are available quarterly in the standard GFS format, although these data continue to be subject to frequent revisions. The ongoing treasury project is expected to improve data quality and timeliness substantially. The budget data are only compiled on a cash basis; compilation of the budget data on a commitment basis would allow monitoring of arrears and facilitate forecasting of future budgetary flows. As of January 1999, the Ministry of Finance has begun publishing consolidated general government balances, which includes the national government (state and municipalities) and an extra-budgetary fund, SoDra. Further work is need to include all extra-budgetary funds, such as the Privatization Fund.

Money and banking

6. The accounts of the Bank of Lithuania (BoL) for the end of each month are available in the second week of the following month, while the consolidated accounts of banking institutions are available within the month following the month of reference. The sectorization and classification of the accounts accord with Fund methodology.

External sector

7. The quarterly data for the balance of payment are often subject to large revisions, due to continued problems associated with the underlying data. As of 1998, the BoL produces quarterly data on Lithuania's international investment position. The transfer of responsibility for the compilation of balance of payments statistics from the Ministry of Finance to the BoL has been beneficial to the extent that it has increased the resources allocated and has utilized the expertise available in this area at the BOL. A STA mission preceding the Article IV mission reviewed the balance of payments methodology and the data revisions. The mission found that the principal issue appeared to relate to the timeliness of the provision of adequate data. Data published three months after the reference quarter showed a high net errors and omissions item, which was then reduced considerably.

Publications of statistics

8. The Lithuanian authorities publish a range of economic statistics through a number of publications, including the DOS's monthly publication *Economic and Social Developments* and the BoL's monthly *Bulletin*. A significant amount of data are available on the Internet: Lithuania's metadata for data categories defined by the Special Data Dissemination Standard

are posted on the IMF's Dissemination Standards Bulletin Board (DSBB); the Bank of Lithuania website (http://www.lbank.lt) provides data on monetary statistics, treasury bill auction results, balance of payments, the international investment position, and main economic indicators; the Department of Statistics' website (http://www.std.lt) provides quarterly information on economic and social development indicators; the Ministry of Finance (http://www.finmin.lt) home page includes data on the national budget, as well as information on laws and privatization;.and the National Stock Exchange website (http://www.nse.lt) has information on daily trading results.

Statistical Data Matrix

(As of July 5, 1999)

	Exchange rates 1/	International reserves	Reserve/ base money	Central bank balance sheet	Broad money	Interest rates	Consumer price index	Exports/ Imports	Current account balance	Overall government balance 2/	GDP/GNP	External debt/debt service
Date of latest observation	...	May 30	May 30	May 30	May 30	Jun. 13	May 1999	Apr. 1999	Q1:1999	May 1999	Q1:1999	Q1:1999
Date received	...	Jun. 8	Jun. 13	Jun. 13	Jun. 13	Jun. 13	May 9	Jun. 11	Jun 30	Jun. 23	May 30	May 23
Frequency of data	...	M	M	M	M	D	M	M	Q	Q	Q	Q
Frequency of reporting	...	M	M	M	M	D	M	M	Q	Q	Q	Q
Source of data	...	A 3/	A 3/	A 3/	A 3/	A,N 3/	A,N	N	N	A	A,N	N
Mode of reporting	...	O	O	O	O	O	C	C	C	C,V	V	C
Confidentiality	...	C	C	C	C	C	C	C	C	B	C	C
Frequency of publication	...	M	M	M	M	D	M	Q	Q	Q	Q	Q

1/ Lithuania has a currency board arrangement, under which the litas is pegged at Llt 4 to the U.S. dollar.
2/ General government balance computed by staff based on separate data provided by the Ministry of Finance, SoDra and HIF.
3/ Via the BoL website (http://www.lbank.lt).

Explanatory Notes

Frequency of data: D-daily, W-weekly, M-monthly, Q-quarterly.
Frequency of reporting: M-monthly, Q-quarterly, V-irregularly in conjunction with staff visits.
Source of data: A-direct reporting by central bank, ministry of finance, or other official agency, N-official publication or press release.
Mode of reporting C-cable or facsimile, V-staff visits, or O-other.
Confidentiality: (B) for use by the staff and the Executive Board, (C) for unrestricted use.

LITHUANIA: INDICATORS OF EXTERNAL AND FINANCIAL VULNERABILITY

Financial and external vulnerability indicators suggest that vulnerability increased during the second half of 1998. However, there are signs that Lithuania is in the process of overcoming the vulnerabilities caused by the crises in Russia and tensions in other emerging markets (Tables 6 and 7).

- Preliminary data suggest that the **current account deficit** increased to 14 percent of GDP in the last quarter of 1998, but is likely to have dropped to 9½ percent of GDP in the first quarter of 1999. Since mid-1998, recorded exports to Russia have fallen sharply, in part reflecting lower re-exports and possibly increased undervaluation of exports. By contrast, exports to the EU have continued to grow, and the share of Lithuania's exports in EU and world markets has increased.

- **External debt** rose in 1998 and early 1999, reflecting mostly higher government or government-guaranteed borrowing, including Eurobond issues. The debt service ratio increased from 11 percent of exports of goods and services in 1997 to 18 percent in 1998. However, the **maturity structure** of external debt remained favorable, with short-term debt accounting for less than 10 percent of the total stock of foreign liabilities at end-1998.

- Lithuania was able to **return to international capital markets** relatively quickly following the crisis in Russia in August 1998. However, access to foreign financing has become more costly, as evidenced by the relatively high interest rate on the government's large Eurobond issue in early 1999 (475 basis points above the corresponding German bonds). The spread between the yield on Lithuania's 1997 Eurobond and the benchmark bond declined following its peak in October 1998 and fluctuated at around 350 basis points in June 1999 (Figure 3). In early July 1999, the government placed a five-year euro 50 million Eurobond at 374 basis points above the five-year German bond.

- The **share of foreign currency denominated loans and deposits** in the respective banking sector totals has increased, in part reflecting interest rate developments. The domestic **banking sector** appears to have been able to weather the Russia crisis relatively well. Direct exposure to Russian debt was limited and banks reported (moderate) profits in 1998. According to BOL data, all banks have since October 1998 complied with prudential regulations. Banks' loan portfolios have improved since end-1997. However, the quality of loan portfolios may deteriorate in the months ahead because of lower economic growth and higher real interest rates.

Table 6. Lithuania: Indicators of Financial Sector Vulnerability, 1997-99
(In percent, unless otherwise indicated)

	1997	1998			Latest Est.	Date
		June	Oct.	Dec.		
Indicators of Financial Sector Vulnerability						
Domestic credit (annual growth)	37.6	59.7	30.4	16.8	31.7	May 99
Commercial bank reserves (in percent of total deposits, end-period)	15.7	19.7	20.9	26.2	18.5	May 99
Cash	4.0	3.7	2.8	4.3	3.5	May 99
Reserves held at the BoL	11.6	16.0	18.1	21.9	14.9	May 99
Of which: Required reserves	8.2	13.6	13.9	13.1	12.7	May 99
Official risk indicators 1/						
Share of non-performing loans in total loans 2/	28.3	19.1	14.1	12.9	12.2	Mar. 99
Risk-based capital asset ratio (capital over risk-weighted assets) 3/	10.8	14.1	18.2	23.8	22.4	Apr. 99
Leverage ratio 4/	5.9	8.6	11.7	14.9	14.8	Mar. 99
Financial sector risk factors 5/						
Share of foreign currency loans in total lending	39.7	48.6	51.2	55.8	58.8	May 99
Share of foreign deposits in total deposits	32.6	35.9	38.2	36.4	37.4	May 99
Share of foreign currency denominated liabilities in total liabilities	33.2	36.4	39.5	36.5	36.3	May 99
Short-term loans in percent of total loans	61.1	55.6	48.9	45.9	47.0	May 99
Demand deposits in percent of total deposits	66.8	64.6	63.4	62.3	57.2	May 99
Share of private credit collateralized by real estate 6/	12.9	13.7	13.3	12.0	11.5	Mar. 99
Share of real estate sector in private credit 6/	4.3	3.5	4.2	3.0	3.0	Mar. 99
Market assessment						
Share prices of financial institutions 7/	210	91	44	55	56	July 99
Spread between lowest and highest interbank and or deposit rates 8/ 9/	500	200	200	268	188	June 99

Sources: Bank of Lithuania; and National Stock Exchange of Lithuania.

1/ Prudential standards are broadly at international levels, and there is a full program of on-site and off-site supervision.
2/ Includes loans overdue for 31 days. The classification of loans may be adjusted according to the borrower's standing and loan restructuring and refinancing (See Resolution on the Board of the Bank of Lithuania on the Approval of the Regulations for Classification of Doubtful Assets, April 24, 1997 No. 87).
3/ The minimum capital adequacy ratio was aligned with the Basle methodology on January 1, 1997.
4/ Defined as the ratio of total capital to total liabilities; an increase in the ratio indicates improvement.
5/ Deposit money banks.
6/ Percent of total loans.
7/ Vilniaus and Hermis Banks; simple average of share prices.
8/ Interbank loan rate; basis points; end of period.
9/ As of January 1, 1999, the difference between the average of the highest and lowest Vilnius Interbank Offered rate (VILIBOR) and Vilnius Interbank Bid rate (VILIBID).

Table 7. Lithuania: Indicators of External Sector Vulnerability, 1997-99
(In percent of GDP, unless otherwise indicated)

	1997	1998			1999	Date of latest
		June	Oct.	Dec.	Latest Est.	Date
Financial indicators						
Public sector debt 1/	21.2	20.0	21.1	22.5	24.0	Mar. 99
Broad money (percent change, 12-month basis)	34.1	23.5	15.1	14.5	20.1	May 99
Broad money to reserves	1.7	1.6	1.3	1.4	1.6	May 99
Private sector credit (percent change, 12 month basis)	18.9	28.5	25.7	16.9	19.0	May 99
31 day T-bill yield	6.6	7.3	10.3	8.7	7.6	June 99
31 day T-bill yield (real) 2/	-1.8	1.3	6.7	6.3	7.0	June 99
External Indicators						
Exports, goods&svcs.(GS) (percent change, 12-month basis in US$)	24.1	6.2	-6.2	-20.8	-23.1	Mar. 99
Imports GS (percent change, 12-month basis in US$)	25.1	6.4	9.1	-15.5	-21.3	Mar. 99
Current account balance	-10.2	-10.8	-13.1	-14.4	-9.6	Mar. 99
Capital and financial account balance	11.5	8.0	22.1	8.3	...	Dec. 98
Gross official reserves (in mil US$)	1,063	1,163	1,491	1,462	1,355	May 99
Central Bank foreign currency exposure (in mil US$) 4/	1,045	1,126	1,183	1,290	1,053	May 99
Net foreign assets of financial sector (in mil US$) 5/	78	-94	-159	-120	-143	May 99
Short term foreign liabilities of the financial sector (in US$) 5/	...	144	238	245	...	Nov. 98
Foreign currency exposure of the financial sector (in mil US$) 4/ 5/	-1	-91	-186	-128	-81	May 99
In percent of total liabilities	0.0	-3.8	-7.3	-4.8	-2.9	May 99
Official reserves in months of imports of goods and services (GS)	2.1	2.1	2.8	2.8	3.5	Mar.99
Total short term external debt to reserves (in percent) 3/	20.2	19.8	16.8	18.1	...	Dec. 98
Total short term external debt (million US $)	215	230	256	265	...	Dec. 98
Government 1/	54	50	45	136	148	Mar. 99
Enterprises	148	160	140	93	...	Dec. 98
Banks 6/	13	44	71	35	...	Dec. 98
Total external debt 7/	25.7	25.1	25.0	26.3	...	Dec. 98
o/w: Public sector debt	12.0	13.4	14.5	13.4	...	Dec. 98
Total external debt to exports GS	48.6	55.1	52.4	57.3	...	Dec. 98
External interest payments to exports GS	2.7	3.1	2.6	4.6	...	Dec. 98
External amortization payments to exports GS	7.6	15.7	15.1	13.7	...	Dec. 98
Total external debt 8/	34.1	...	...	35.0	...	Dec. 98
Exchange rate (per US$, period average)	4.0	4.0	4.0	4.0	4.0	July 99
REER appreciation (+) (12 month basis) 9/	13.9	6.3	15.6	17.0	23.5	Apr. 99
Financial Market Indicators						
Stock market index, end period 10/	1,863	1,582	1,082	1,089	1,001	July 99
Market capitalization (shares, percent of GDP)	17.9	16.5	13.4	13.8	14.2	May 99
Foreign currency debt rating 11/	BBB-	BBB-	BBB-	BBB-		Dec. 98
Spread of benchmark bonds (basis points, end of period) 12/	105	220	795	499	346	Jun. 99
Memo item: Nominal GDP in mil US $	9,550	10,605	10,605	10,692	10,916	July 99

Sources: Bank of Lithuania, Department of Statistics, National Stock Exchange of Lithuania, Bloomberg, Baltic News Service, Information Notice System.

1/ Public and publicly guaranteed debt.

2/ CPI-based inflation.

3/ Liabilities 1 year and under; remaining rather than original maturity.

4/ Net open position. For commercial banks, includes off-balance sheet foreign currency liabilites, such as short forward position as of July 1998.

5/ Deposit money banks.

6/ From the International Investment Position.

7/ Includes IMF. Excludes trade credits, currency and deposits, and other liabilities.

8/ Includes IMF and trade credits, and currency and deposits, and other liabilities.

9/ CPI-based REER

10/ LITIN-G price index, calculated for all issues that have been quoted in the current trading list in the past three months, excluding treasury bills and shares of investment companies.

11/ S&P investment grade rating.

12/ Spread of 5-year Eurobond ($200 million) issued in July 1997 above the rate on U.S. treasury bill maturing July 31, 2002.

LITHUANIA: MEDIUM-TERM MACROECONOMIC FRAMEWORK

The baseline medium-term macroeconomic framework prepared by the staff is based on the following key assumptions:

- in 1999, **exports** are projected to rise only marginally (1 percent), before export growth picks up again in the year 2000 and beyond. Export growth to Western markets and the other two Baltic countries will remain relatively strong in the years ahead, although somewhat dampened by the current slowdown or pause in growth in these countries. The scenario does not assume a quick recovery of exports to Russia or other CIS countries. Exports of goods and non-factor services are expected to benefit from major investments coming on stream (e.g., Butinge off-shore oil terminal) and continued foreign direct investment in export industries. Imports are expected to decline this year, reflecting largely the slowdown in GDP growth in Lithuania as well as lower customs warehouse imports and re-exports destined for CIS countries. Over the medium term, imports are projected to rise broadly in line with GDP;

- **private investment** is expected to remain high at about 25 percent of GDP over the medium term;

- Lithuania will have **access to international financial markets** at lower costs than those currently prevailing. Foreign direct and portfolio investments are projected to remain strong in the years ahead, assuming, in particular, that privatization of large enterprises in the energy, banking, and other sectors will continue;

- Lithuania will **keep the present exchange rate**, as competitiveness is maintained through structural reforms and productivity growth;

- a **major upfront fiscal adjustment** is achieved, as discussed below; and

- the authorities will proceed vigorously with the implementation of **structural reforms,** as discussed in the main text of the staff report;

Based on these assumptions, **real GDP growth** would begin to increase again in the second half of 1999, reaching an estimated annual growth rate of about ½ percent in 1999 and 4 percent in 2000. Growth is expected to be 5-6 percent annually over the medium term (Table 5). GDP growth would be underpinned by rebounding exports and private domestic demand.

Annual **consumer price inflation** is projected to remain in the 2-3 percent range over the medium term. The continued differential vis-à-vis the euro zone largely reflects further adjustments in administered prices, including electricity tariffs, increases in excise tax rates, and relative productivity growth in the context of a fixed nominal exchange rate.

The **current account deficit** is projected to narrow progressively over the medium term and reach approximately 4 percent of GDP in the year 2004. National saving is projected to rise

steadily, initially as a result of fiscal adjustment and later on account of increased non-government saving, underpinning the current account adjustment. It is expected that **capital inflows** will continue to finance the current account deficit, allowing a further steady increase in official foreign exchange reserves (albeit at a slower pace than in 1997 and 1998). **External debt** as a share of GDP and the external debt service ratio will continue to rise until reaching a peak in the year 2002 at 38 percent and 27 percent, respectively, and will subsequently decline.

A **major fiscal adjustment effort** over the next 1½ years would be the linchpin and starting point of the government's medium-term macroeconomic policy strategy. The framework assumes a fiscal deficit of 4½-5 percent of GDP in 1999, reflecting a relatively small deficit in the second half of the year, and 0-1 percent of GDP in 2000. The fiscal accounts are assumed to remain balanced thereafter, reflecting continued efforts towards fiscal retrenchment. The projections also assume that compensation payments under the Savings Restitution Plan will be stretched out over time. In addition, the government is expected to phase out onlending and off-budget spending financed by privatization proceeds. Such proceeds would be saved and used to retire debt and/or finance systemic pension reform (the latter would add significant expenditures to the budget over the medium term).

It is assumed that government expenditures relating to EU accession and NATO membership will increase over the medium term, but to the extent that these are not financed by external grants they would be offset by cuts in administrative outlays and civil service retrenchment. On the revenue side, the tax revenue to GDP ratio is expected to increase. It is assumed that the corporate profit tax will be maintained, and that revenue gains will be achieved due to broadened tax bases (e.g., raising the cap on payroll tax contributions, abolishing exemptions and preferential income tax rates), increased property taxation, and tax reforms undertaken in the context of EU accession (e.g., higher excise tax rates).

Downside Risks

Table 8 illustrates the potential impact on external indicators of adverse policies and external developments. **Failure to undertake the assumed fiscal adjustment in 1999 and 2000** would tend to generate a higher current account deficit in the year 2000 and beyond than in the baseline scenario. For example, if the fiscal deficit remains high in 1999 (5½ percent of GDP) and is subsequently reduced only moderately, the current account deficit could remain above 10 percent of GDP through the year 2001. The debt service ratio will reach 29 percent in the year 2002 and external debt would rise to 45 percent of GDP over the medium term (Scenario A in Table 8).

There are also risks stemming from possible **external shocks**. Scenarios B-D in Table 8 illustrate the effects on indicators of external sustainability of such developments:

Export growth could be lower than projected under the baseline scenario because of a further slowdown in economic growth in Western trading partners or a loss of external competitiveness. The external debt indicators are quite sensitive to the export growth

assumptions. For example, if exports increase by 1 percentage point per year less than under the baseline scenario, the current account deficit would, ceteris paribus, remain at about 10 percent of GDP in 2000 and at around 8 percent of GDP annually over the medium term. In the event, the external debt position could come under pressure.

Foreign direct investment inflows may not be forthcoming as projected, or **access to external borrowing** could become more limited and expensive. Under such circumstances, external debt service payments would increase considerably compared with the baseline scenario. For example, if foreign direct investment flows were to remain 25 percent below the level of the baseline scenario, external borrowing would need to be increased substantially although imports would also be lower. Compared with the baseline scenario, external debt service payments and external debt would be significantly higher. An increase in interest rates and a larger share of short-term borrowing would have a similar effect.

Table 8. Lithuania: External Sector Indicators under Alternative Scenarios, 1998-2004

	1998	1999	2000	2001	2002	2003	2004
		Projections					
Baseline scenario							
Fiscal balance (in percent of GDP)	-5.8	-4.6	-0.9	0.0	0.0	0.0	0.0
Current account balance (in percent of GDP)	-12.1	-10.8	-9.4	-8.1	-6.8	-5.3	-3.7
Debt service/exports of goods and services (in percent)	17.3	22.2	24.7	23.3	27.2	23.0	23.5
Gross official reserves/short-term debt (in percent)	600	575	456	384	323	309	318
External debt (in percent of GDP)	26.3	32.5	35.7	37.4	38.1	37.6	36.0
Scenario A - Larger fiscal deficit compared with the baseline scenario							
Fiscal balance (in percent of GDP)	-5.8	-5.5	-2.8	-1.4	0.0	0.0	0.0
Current account balance (in percent of GDP)	-12.1	-11.4	-10.6	-10.1	-8.9	-7.5	-5.9
Debt service/exports of goods and services (in percent)	17.3	22.2	24.9	24.5	28.9	25.3	26.3
Gross official reserves/short-term debt (in percent)	600	567	441	369	307	291	297
External debt (in percent of GDP)	26.3	33.1	37.5	41.0	43.5	44.8	44.8
Scenario B - Export growth lower by 1 percentage point per year compared with the baseline scenario							
Current account balance (in percent of GDP)	-12.1	-10.8	-9.8	-9.0	-8.1	-7.1	-6.0
Debt service/exports of goods and services (in percent)	17.3	22.2	26.5	26.8	32.8	30.9	34.2
Gross official reserves/short-term debt (in percent)	600	575	451	374	308	287	286
External debt (in percent of GDP)	26.3	32.5	36.6	39.9	43.1	45.8	48.1
Scenario C - Foreign direct investment lower by 25 percent compared with the baseline scenario							
Current account balance (in percent of GDP)	-12.1	-10.8	-8.9	-7.7	-6.4	-4.9	-3.2
Debt service/exports of goods and services (in percent)	17.3	22.2	25.3	24.4	28.6	24.5	25.1
Gross official reserves/short-term debt (in percent)	600	575	447	372	311	296	307
External debt (in percent of GDP)	26.3	32.5	36.4	38.7	39.9	39.7	38.3
Scenario D - Interest rates 200 basis points higher and 20 percent increased short-term borrowing compared with baseline scenario							
Current account balance (in percent of GDP)	-12.1	-10.8	-9.5	-8.3	-7.0	-5.6	-4.0
Debt service/exports of goods and services (in percent)	17.3	22.2	26.7	25.7	29.9	25.8	26.4
Gross official reserves/short-term debt (in percent)	600	575	433	354	291	275	283
External debt (in percent of GDP)	26.3	32.5	35.8	37.7	38.6	38.4	37.1

Source: Data provided by the Lithuanian authorities; and staff estimates and projections.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 99/68
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IMF Concludes Article IV Consultation with Lithuania

On July 26, 1999, the Executive Board concluded the Article IV consultation with Lithuania[1].

Background

Lithuania has made impressive progress in macroeconomic stabilization and market transition. Following the introduction of the currency board in 1994, inflation has come down rapidly, and market reforms have provided a sound basis for economic recovery. The progress suffered setbacks in the wake of the Russian crisis, however, as a fall in exports led to lower growth and initially an increase in the current account deficit.

The economy cooled down rapidly starting in the third quarter of 1998, while inflation continued on a downward trend; the current account deficit widened in the second half of 1998 but subsequently contracted. Real GDP growth came to a halt in the fourth quarter of 1998, while preliminary data suggest that real GDP fell by 5¾ percent year-on-year in the first quarter of 1999. Meanwhile, reorientation of food supplies from the Russian to the domestic market, appreciation of the litas against the currencies of western trade partners (the litas is pegged to the U.S. dollar), and softer domestic demand all contributed to a decline in inflation to a 12-month rate of ½ of one percent in June 1999. The current account deficit widened from 10 percent of GDP in 1997 to 12 percent of GDP in 1998, before falling to 9½ percent in the first quarter of 1999. As the current account deficit has been financed mainly by privatization-related foreign direct investment, external debt increased only moderately, from 25¾ percent of GDP at end-1997 to 26½ percent at end-1998.

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[1]Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

Fiscal policy became more expansionary starting in mid-1998, reflecting in large part use of privatization proceeds on current spending. While central government expenditure in 1998 stayed within the limits approved by the Parliament, the government spent privatization proceeds on off-budget items. The most important items were the Savings Restitution Plan (SRP) and support for companies affected by the Russian crisis. Capital expenditures, by contrast, remained below 3 percent of GDP in 1998. Government revenue held up well in 1998. Overall, the fiscal deficit rose to from 2 percent of GDP in 1997 to 5¾ percent of GDP in 1998.[2] In January–May 1999, weak revenue due to the decline in economic activity, further SRP payments, and net lending contributed to a fiscal deficit of 4 percent of projected annual GDP.

The currency board has withstood pressures caused by the turmoil in international markets. Starting in September 1998, there were net foreign exchange outflows through the currency board, which initially led to an increase in interest rates to about 14 percent in October (on three-month treasury bills). From October onwards, the government used privatization funds to meet part of its financing need, while foreign exchange outflows tapered off. By June 1999, interest rates had declined to about 10 percent. The foreign exchange coverage under the currency board has remained comfortable, at about 143 percent of litas liabilities at end-May. Reflecting a resumption in credit growth and the SRP payments, broad money growth increased from 14½ percent (12-month rate) in December 1998 to 20 percent in May 1999.

Recent progress in privatization has been good, while government support and weaknesses in the framework for market entry and exit (including bankruptcy procedures) have tended to soften enterprises' budget constraints. The Privatization Agency has been restructured as called for under the Privatization Law of December 1997, and completed 345 privatization transactions with a total value equivalent to 5⅓ percent of GDP in 1998. The *electricity sector* has experienced intensifying cashflow problems, because of high costs, lags in adjusting tariffs, and difficulties in collecting payments on exports. In *agriculture*, the progress in reducing government support has suffered setbacks against the background of low world commodity prices and a severe impact on food industries of the Russian crisis.

The banking system has so far withstood the Russian crisis, because banks had limited direct exposure to Russia. A major strengthening of prudential regulations and supervision since the banking crisis in 1995/96, as well as a major shake-out in the sector during that period, have helped bolster the banking system. Worries remain, however, pertaining to credit quality following the Russian crisis, short-term foreign borrowing, and market concentration.

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[2]The IMF definition of the general government includes the state and local governments, as well as extra-budgetary funds such as the social insurance fund (SoDra), the Health Insurance Fund, and the Privatization Fund. Privatization proceeds are counted as financing, while the spending of such proceeds is counted against the deficit.

Lithuania's economic database is generally adequate for economic analysis, although large revisions to balance of payments and national accounts data underscore the need for improvements.

Executive Board Assessment

Executive Directors commended Lithuania's significant progress in economic stabilization and market reform since independence. Economic performance had suffered setbacks in the wake of the Russian crisis, whose impact policies since mid-1998 had aimed to cushion. The challenge facing the authorities now was to take strong and early actions to continue Lithuania's earlier achievements so as to return to sustained economic growth and to ensure external sustainability. Directors noted the advances in structural reform in recent years but, partly because of Lithuania's EU accession plans, considered that an acceleration of actions was needed.

Directors endorsed the authorities' decision to maintain the currency board arrangement. However, noting the impact of external events in the region on top of an already high external current account deficit and rising debt, they considered that further efforts to maintain macroeconomic stability were called for. Directors recommended that the authorities tighten fiscal policy and stand ready to act if balance of payments pressures emerged. They encouraged the authorities to maintain their close policy dialogue with the Fund.

While not viewing external competitiveness as a problem at present, Directors were concerned at the relatively rapid growth in wages in recent years. The fact that wage pressures remained despite high unemployment underscored the need to ensure labor market flexibility.

Directors agreed on the need to proceed cautiously in changing the exchange rate peg to an interim basket before an eventual peg to the euro, but several Directors were not convinced of the case for such an interim move. They emphasized the need for careful preparation for any eventual exit from the currency board arrangement.

Directors agreed with the government's emphasis on fiscal policy as the cornerstone of the external adjustment strategy in the near term. They looked forward to early implementation of the government's expenditure reduction plans for 1999, especially for current outlays. Directors considered that the 2000 budget should continue the adjustment process, with the focus on further restraint on current expenditure. In this connection, they called for public sector wage restraint and civil service reform. Directors advised against any tax measures that could undermine fiscal adjustment and suggested that any reduction in tax rates be accompanied by a lowering of exemptions.

To support fiscal adjustment, Directors called for a strengthening of budget procedures. They encouraged the authorities to establish a fund for investment of privatization proceeds, with clear guidelines for its utilization, and urged the adoption of the new Budget Law. Directors saw a need for an acceleration of pension reform, to which better payroll tax collection would contribute.

Regarding other structural reforms, Directors welcomed the acceleration of privatization, the new Competition Law, and the revision of the Bankruptcy Law. They called for the scaling back of budgetary support to enterprises and of import protection for specific sectors—particularly agriculture and the oil industry—and the simplification of regulations and licensing requirements. These efforts should serve to scale back the role of the state in the economy, while enhancing competition and improving the environment for greater private sector activity.

Directors welcomed the Bank of Lithuania's efforts to strengthen further the supervisory framework, including the decision to implement the Core Principles for Effective Banking Supervision, which had been reflected in greater soundness of the banking system since the banking crisis of 1995-96. While noting the limited direct exposure to Russia of Lithuania's banks, Directors nevertheless expressed concern about the potential secondary effects through domestic borrowers exposed to the CIS. Some Directors also drew attention to the increase in foreign currency lending. These factors called for continued careful monitoring and oversight of the banking system.

Directors commended the authorities' emphasis on ensuring transparency in economic policy and improving economic data. They welcomed the authorities' decision to participate in the pilot project for publication of Article IV consultation staff reports.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 1999 Article IV consultation with Lithuania is also available.

Lithuania: Selected Economic Indicators

	1994	1995	1996	1997	1998
Real Economy			*Changes in percent*		
Real GDP	-9.8	3.3	4.7	7.3	5.1
CPI (period average)	72.1	39.5	24.7	8.8	5.1
Unemployment rate (in percent)	3.8	6.1	7.1	5.9	6.4
			In percent of GDP		
National saving	16.2	14.5	15.3	16.3	13.4
Gross investment	18.4	24.7	24.5	26.5	25.5
Public Finance					
General government balance	-4.8	-4.5	-4.5	-1.8	-5.8
General government debt	10.4	14.3	15.0	16.2	17.0
Money and Credit			*Changes in percent*		
Base money	62.4	35.0	2.2	32.4	28.8
Broad money	63.0	28.9	-3.5	34.1	14.5
Domestic credit to nongovernment	81.8	23.0	-4.4	18.9	16.9
Balance of Payments			*In percent of GDP*		
Current account	-2.2	-10.2	-9.1	-10.2	-12.1
Gross international reserves (in millions of US$)	587	819	850	1,063	1,462
Exchange Rate					
Exchange rate regime			Currency Board Arrangement		
Exchange rate LTL 4 = $ 1					
Real effective exchange rate (1995=100)	100.0	101.2	111.6	127.1	138.5
Of which: EU	100.0	122.8	142.0	170.4	171.1
Baltics	100.0	104.3	108.2	117.1	116.1

Sources: Data provided by the Lithuanian authorities; and IMF staff estimates.

Statement by Kai Aaen Hansen, Executive Director
for the Republic of Lithuania
July 26, 1999

General

First of all, on behalf of my Lithuanian authorities, I would like to thank the staff team for their excellent work in maintaining the uninterrupted dialog and in providing balanced advise throughout the period since the last Fund program expired in 1997. The authorities highly appreciate the on-going exchange of views with the IMF staff, viewed as supporting the goal to promote transparency in the policy-making process, which has also led them to decide to participate in the pilot project for the release of Article IV consultation report.

The events in Russia in August 1998 had a profound effect on the Lithuanian economy. The broad macroeconomic picture has changed dramatically as a result of this exogenous shock, namely, from that of a strong GDP growth, improved fiscal management, progress in structural reforms, and good prospects for further solid developments in the first part of 1998, to one of sharp drop in economic activity, budget revenue shortfall, and deepening in the unemployment rate in the first quarter of 1999. Nevertheless, there are also positive signs: the current account deficit went down to 9.7 per cent of GDP in the first quarter of this year, compared to 12.1 in 1998. Labor market also reacted swiftly and flexibly to the shock, putting a brake on wage growth. Most importantly, prudent behavior of the banking system resulted in its resilience to the shock. Moreover Lithuania continued to maintain its very liberal trade regime in the post-shock period, despite significant protectionist pressures.

My authorities believe that the economy has already taken the brunt of the shock, and expect an overall recovery in the second half of the year. Private market participants also seem to be rather optimistic, forecasting, according to some surveys, a GDP growth of over 4 per cent for 1999, although the official forecasts target 1-2 per cent annual growth.

Fiscal policy

Fiscal policy has been, and is, at the core of attention of policy-makers in Lithuania. A number of positive developments have occurred in this area, and more are in the pipeline. Tax administration has strengthened considerably. The new programming principle for the budget has been adopted, leading to more transparency in fiscal policy. A new Budget Law, which contains important improvements with regard to budgetary management, policy formulation, and transparency, has been prepared for consideration of the Parliament.

Lifted by a brisk GDP growth of 5.1 per cent and improved tax administration, the budget revenues rose in accordance with the Government's forecasts. In the second half of

1998, the Government increased spending in order to (1) smooth out the initial shock from the near-closure of trade markets in the East, and (2) to start the Savings Restitution Program, the latter being financed exclusively by privatization proceeds. As a result, fiscal deficit increased to 5.8 per cent of GDP, with 90 per cent of it financed by privatization receipts. There were no difficulties to finance current spending. The Government was able to return quickly to the Eurobond market before the end of 1998, after the initial halt on lending to emerging markets.

In the beginning of this year, the trade shock started having its strongest effects, leading to a significant shortfall in fiscal revenue. Under-collection of VAT and excise taxes contributed the most to the weak fiscal performance. It should be noted that the authorities' forecasts used in the 1999 budget formation have been overly optimistic, and have been revised downwards. The Government agrees that the situation warrants fast adjustment actions. The new Prime Minister and Finance Minister stand strongly behind the plan to reduce expenditures in order to meet the budget deficit target for the year.

Presently, the Ministry of Finance proposes substantial reductions in this year's expenditures, even larger than those recommended by the staff. The Government already now is well on its way in finding cut spending possibilities, regarding both current and capital spending, partly based on an IMF technical assistance mission that has helped identify measures to reduce government expenditures. The Parliament is envisaging an extraordinary session to consider the proposal. Also, in order to preserve budget revenues at this crucial juncture, the possibility to reduce profit tax instead of abolishment thereof is being considered.

In addition to reacting to the revenue shortfall due to the external trade shock, more importantly full consideration is given to tightening fiscal policy, aimed at reducing the current account deficit. So far, the current account deficit has been fully financed by direct foreign investment and longer-term borrowing, adding little to increased external vulnerability. As both imports and exports have been slowing down since last fall, the current account deficit dropped below 10 per cent of GDP in the first quarter of this year. In order to further reduce the current account deficit, a whole range of measures is being envisaged regarding with both the public and the private sector, especially in view of promoting domestic private savings. To that effect, the Government and the Bank of Lithuania are closely cooperating in order to work out on appropriate measures. Provisionally, such measures, i.e., will include establishing a fiscal stabilization fund as a public savings accumulation instrument, intended, inter alia, to accumulate set asides from privatization proceeds.

Currency Board

In 1997, the Bank of Lithuania, in coordination with the Government, has drawn up a three-stage Monetary Policy Program. Whereas the implementation of the first two parts, namely developing a full range of monetary policy instruments and strengthening the role of

the Central Bank, have been accomplished, the last part i.e., pegging the litas not to the US dollar but, instead, to a currency basket, consisting of the USD and the Euro, while maintaining the basic principles of the existing currency board arrangement, coincided with the adverse external developments and was postponed.

Different timing options have been considered to start the last phase, but it has been generally agreed that the envisaged changes, and especially the re-pegging of the Litas, should be done only when both internal and external developments return to more favorable trends. Reacting to uncertainties voiced by the financial markets, the Bank of Lithuania has officially stated on numerous occasions that re-pegging of the Litas would (1) be announced at least 6 months in advance before the actual event, and (2) would not result in revaluation or devaluation of the Litas, and (3) the domestic monetary base would continue to be fully backed by foreign currency reserves. Subject to favorable market developments, the Bank of Lithuania intends to restart the discussions with the Government on the re-pegging this fall.

The authorities have taken note of the IMF staff's recommendation to consider a pegging of the Litas directly to the Euro, skipping the transitional phase, i.e., pegging the litas at a 50:50 percent rate to a Dollar/Euro basket. Although, based on the trade pattern of Lithuania, the basket peg still remains the preferred option, the authorities will keep an open mind on this issue, and will consider all the relevant factors, including EU accession requirements, technical implementation of the peg, and others, before taking the final decision.

Structural reforms

Structural reforms have progressed through the year until summer 1999. Privatization moved forward at a high speed, crowned by the sale of the telecommunications company. The process of privatization of the two state-owned banks is under way, with the understanding that all Government-controlled shares will be offered for sale to strategic investors. The negotiations with the strategic investor over the sale of the oil complex have been extended to settle technical factors, and otherwise are in their late stage of completion.

The Pension Law has been adopted, and a set of relevant by-laws and changes to the existing laws are being drafted, to allow the law to become effective from the start of 2000. The new law has signaled a step towards the three-tier pension system. Moreover various improvements regarding the management of the public sector and banking sector have already been adopted or are under consideration.

The energy and agricultural sectors are experiencing financial difficulties, and require rapid structural reforms. In the energy sector, the debt of a neighboring country for the export of electricity has reached some $100 million. Numerous debt settlement negotiations did not produce any results so far. Currently there is also public debate on a strategy of closing the nuclear power station, which supplies over 80 per cent of the country's electricity. Such a step

is expected to carry massive costs, and will most likely require significant tariff increases in the medium and long-term.

The agricultural sector was hit hard by the near-closure of the Eastern markets for its exports last fall. The Government moved in to support the farmers and producers with increased subsidies and certain trade measures at the end of 1998. This year, however, due to the unfavorable budget situation, the Government sharply limited its support. The structural efforts will be oriented towards support of private farming and targeting of the subsidies in a more efficient way. Remaining trade barriers will be removed before the WTO acceptance process is completed.

Most importantly, the new Government has committed itself to pay particular attention to speed, efficiency, and transparency of the structural changes. The macroeconomic circumstances call for rapid implementation of reforms which have been overdue, such as withdrawing state support for poorly performing companies, tightening budget constrains on state-owned enterprises, reducing market entry regulations to foster growth of new businesses, implementing a new bankruptcy law to improve private market performance and effectiveness. The new Government, having support of the Parliament, the President, and the public, is determined to carry out these reforms.

Banking sector

Lithuanian banks weathered the external shock with limited damages. All banks finished fiscal 1998 with profits, even after making additional provisions for possible new bad loans, and were in compliance with all prudential requirements set by the central bank. This year continues to remain profitable for banks, and supervisory requirements are being met continuously. New foreign banks have moved into the country, either through buying stakes in the existing banks, or by establishing their own branches and subsidiaries. The Bank of Lithuania has adopted the internationally recommended Core Principles for Effective Banking Supervision, and is currently integrating these principles into its supervisory function.