Statement by Kai Aaen Hansen, Executive Director
for the Republic of Lithuania
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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.