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Lithuania—Recent Economic Developments

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INTERNATIONAL MONETARY FUND

REPUBLIC OF LITHUANIA

Recent Economic Developments

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<u>Contents</u>	<u>Page</u>
Basic Data	iv
Foreword	v
I. Overview of Recent Economic Developments	1
II. Developments Under the Currency Board Arrangement: The Record and Policy Issues	7
1. Introduction	7
2. Economic policy credibility	8
a. General considerations	8
b. The Lithuanian experience	10
3. Inflation	13
a. Overall developments	13
b. Sources of inflation	13
4. External competitiveness	18
a. Methods for assessing competitiveness	18
b. Real exchange rate indexes and indirect indicators	19
c. Equilibrium U.S. dollar wage rates	20
III. Banking Crisis and Policy Response	22
1. Structure of the banking system	22
2. Prudential regulations	22
3. Deposit insurance	24
4. The banking crisis	24
5. Bank restructuring plan	24
IV. Medium-Term Fiscal Issues	26
1. Institutional framework for fiscal policy implementation	26
2. Pension reform	27
3. Government borrowing strategy	31

	<u>Contents</u>	<u>Page</u>
V.	Trade Reform and Growth	32
1.	Trade policy developments	32
2.	Economic effects of lower tariffs	36
<u>Text Tables</u>		
1.	Inflation and Undervaluation	15
2.	Price and Wage Inflation by Sector	17
3.	Average Retirement Age in Public Old-Age Schemes in OECD Countries, Poland, and the Baltics in 1990	28
4.	Agricultural Tariffs in Estonia, Latvia, and Lithuania	34
5.	Agricultural Tariffs in the Czech and Sloval Republic and Poland	35
6.	Agricultural Tariffs in Armenia, Georgia, and Russia	35
7.	Agricultural Tariffs in the European Union and the United States	36
8.	Model Equations	37
9.	Effects of Lowering Agricultural Import Tariffs from a Weighted Average of 27 1/2 Percent to 20 percent	39
Appendix I. Background tables		
1.	Gross Domestic Product by Sector at Current Prices	40
2.	Industrial Production Sold by Sectors	41
3.	Real Sector Indicators	42
4.	Labor Force and Employment	43
5.	Registered Unemployment at Labor Exchanges	44
6.	Employment Distribution	45
7.	Wages and Prices	46
8.	Average Monthly Wages	47
9.	Supply and Use of Energy	48
10.	Electricity Production and Consumption	49
11.	Domestic Consumer's Energy Arrears	50
12.	Summary of General Government Fiscal Operations	51
13.	General Government Revenue	52
14.	General Government Expenditure	53
15.	Monetary Authorities	54
16.	Monetary Survey	55
17.	Interest Rates at Commercial Banks	56
18.	Balance of Payments	57
19.	Geographic Distribution of Trade with the East in 1995	58
20.	Exports to Western Countries by Geographic Destination	59
21.	Imports from Western Countries by Country of Origin	60
22.	Commodity Composition of Trade	61
23.	Foreign Direct Investment	62
Appendix II. Summary of the Tax System (March 31, 1996)		63

Contents

Page

Charts

1.	Nominal Interest Rates	12a
2.	Real Interest Rates	12b
3.	Monetization and Foreign Exchange Flows	12c
4.	Growth and Inflation	12d
5.	External Trade Indicators	12e
6.	Inflation in Consumer Prices	14a
7.	Inflation and Trend Inflation	14b
8.	Inflation and Relative Price Variability	14c
9.	Money and Prices	16a
10.	Inflation and Wages	16b
11.	CPI by Component	18a
12.	Effective Exchange Rates	20a
13.	Average Monthly Wages	20b
14.	Indirect Indicators of Competitiveness	20c
15.	Pension Cost Indicators	28a
16.	Average Pension, and Average and Minimum Wage	28b
17.	Effects of Agricultural Tariff Reduction	36a

Lithuania: Basic Data

Social and demographic indicators (latest available data)

Area (sq. km.)	65,300
Population density (inhabitants per sq. km.)	56.9
Population (thousands)	3,715
Life expectancy at birth	
Men	62.8
Women	74.9
Infant mortality rate (per 1,000 births)	13.9
Hospital beds (per 1,000 inhabitants)	11.1
Physicians (per 1,000 inhabitants)	4.0

	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	<u>(In percent of GDP)</u>					
<u>National accounts</u>						
Domestic demand	110	91	98	109	104	104
Consumption	74	68	80	86	85	86
Gross capital formation	34	22	18	23	19	18
Foreign balance	-9	9	2	-9	-4	-4
GDP	100	100	100	100	100	100
	<u>(Percentage changes)</u>					
GDP/NMP <u>1/</u>	-5.0	-13.4	-37.7	-24.2	1.0	3.1
Consumer/retail prices <u>2/</u>	8.4	224.7	1020.5	410.4	72.1	39.5
Real wages <u>3/</u>	7.1	-19.9	-17.2	-45.3	20.6	1.2
	<u>(In thousands)</u>					
<u>Labor market</u>						
Total employment	1,853	1,898	1,855	1,778	1,675	1,644
Of which: in state sector	1,440	1,334	1,089	815	645	517
Unemployment rate (in percent) <u>4/</u>	...	0.3	1.3	4.4	3.8	6.1
	<u>(In millions of U.S. dollars)</u>					
<u>Balance of payments</u>						
Trade balance	-1,902	1,848	101	-283	-307	-334
FSU	103	1,978	-114	-479	-446	-490
Others	-2,005	-130	215	196	138	156
Current account balance, excl. official transfers	...	2,256	102	-239	-234	-252
(as percent of GDP)	...	10.6	5.6	-8.4	-4.3	-3.2
	<u>(Percentage changes)</u>					
<u>Money and credit</u>						
Broad money	55	162	351	124	64	31
Credit to the economy	21	128	532	165	105	30
Interest rate (in percent) <u>5/</u>	2-10	7	135	85	29	26
	<u>(In percent of GDP)</u>					
<u>General government finances</u>						
Revenue	43.7	41.4	32.1	28.4	24.6	25.0
Expenditure and net lending	49.1	38.7	31.3	33.3	29.3	27.9
Financial balance	-5.4	4.8	0.8	2.4	-1.5	-1.8
Fiscal balance	-5.4	2.7	0.8	-3.1	-4.2	-3.3

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

1/ NMP for 1990, GDP thereafter.

2/ Retail price index for 1990, consumer price index thereafter.

3/ Average wages deflated by retail/consumer price index.

4/ Calculated on the basis of registered unemployed.

5/ Rates on operating credits for state enterprises from the Bank of Lithuania through 1991, on 30-90 day credits thereafter. Data refer to end of period.

Foreword

This report--prepared by the Fund mission team for the 1996 Article IV consultation with Lithuania--provides a summary of recent economic developments and background analyses of key aspects of economic policies. The report is organized as follows: Chapter I gives an overview of recent economic developments ^{1/} and the support for Lithuania's reform effort provided by the International Monetary Fund; Chapter II discusses the experiences with the currency board arrangement in terms of policy credibility, inflation, and external competitiveness; Chapter III reviews the recent banking crisis and the authorities' policy response; Chapter IV describes medium-term fiscal issues, focussing on strengthening of fiscal institutions, reform of the pension system, and the Government's borrowing strategy; and Chapter V examines external trade reforms and their economic effects. Appendix I contains economic statistical tables and Appendix II summarizes the tax system as of March 31, 1996.

^{1/} Developments before 1995 are described in more detail in IMF Economic Reviews: Lithuania, for 1992, 1993, and 1994, and in IMF Staff Country Report No. 95/82.

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I. Overview of Recent Economic Developments

Developments in 1991-1994. When Lithuania regained its independence in 1991, it inherited an economy which was well developed relative to most parts of the Soviet Union. Its role in the central-planning system of the former Soviet Union had been primarily as a supplier of manufactured goods; in effect, the economy was strongly outward-oriented which had provided the basis for a relatively high per capita income. Besides manufacturing, agriculture accounted for a substantial share of output.

Since independence, the Government has been engaged in a effort to transform the economy from state ownership and central planning to one based on market principles. Although the starting position was relatively favorable, the process of economic transition was initially complicated by the breakdown of the former external trade system and a large terms of trade loss stemming from higher prices for energy imports, both of which contributed to dramatic declines in output and real wages. Real GDP, as well as real wages, are estimated to have fallen by a cumulative 60 percent in 1991-93. Inflation accelerated sharply, due to price liberalization, elimination of a large monetary overhang, and exchange rate depreciation, and reached a peak of over 1,000 percent per annum in 1992. In spite of the terms of trade loss, the external current account showed large surpluses in 1991-92, reflecting the initially limited availability of external financing. In 1993, the current account balance turned into a large deficit, of 8 1/2 percent of GDP, which however was halved in 1994.

The first phase of stabilization and liberalization had been broadly completed by early 1995. Inflation has been 2-3 percent per month since mid-1994, positive economic growth resumed in 1994, and the current account deficit has been falling. Also, domestic prices, external trade, and capital transactions had been largely liberalized, competition has been promoted by the State Price and Consumer Protection Office, and the first phase of privatization--based mainly on vouchers and covering about one-half of state assets--had been essentially completed.

Economic activity. Economic growth resumed in 1994 and gained further momentum in 1995; real GDP increased by an estimated 3 percent in 1995. Growth in 1995 was driven by the industrial sector, while agriculture performed poorly. The immediate effects of the banking problems on economic activity, and on other macroeconomic developments, have been limited. Nevertheless, while data on industrial production and retail trade indicate continued growth in the first part of 1996, the seasonal upturn in the first quarter of the year was weaker than normal, and companies' orders declined while their stocks of finished products increased.

Price developments. Inflation (measured by the CPI) decelerated sharply from the peak in 1992, falling to 39 1/2 percent (annual average) in 1995. The decline in inflation measured by the PPI was similar to that in the CPI. The decline in inflation reflected the reduction in the monetary overhang, monetary policy tightening in late 1993, as well as the completion

of the first round of relative price adjustments. The establishment of a currency board arrangement in April 1994 anchored inflation at a lower level. Nevertheless, while inflation since then has been on a declining trend, it has remained at 2-3 percent per month, which is attributable mainly to the real exchange rate moving toward its equilibrium level from a position of initial undervaluation and increases in relative prices--including administered prices--in a situation of downward price rigidity.

Wage developments. Through 1991, a legally binding wage policy was in place. In mid-1993, the binding wage policy was replaced by voluntary wage guidelines. Since then, direct government intervention in wage determination has been limited to the stipulation of a minimum wage; wage bargaining is conducted at the local level. Real wages have continued to recover from the trough in 1993; in 1994, average real wages rose by some 21 percent, followed by a further 1-2 percent increase in 1995.

External sector developments. The current account deficit is estimated to have declined, from 4 percent of GDP in 1994 to 3 percent of GDP in 1995, as strong growth of manufacturing exports and dampened energy imports offset a major weakening of the terms of trade. The reorientation of external trade toward western markets and Lithuania's re-integration with western Europe have continued; Fund staff estimates indicate that in 1995 about half of merchandise exports went to western countries, while one-third of merchandise imports came from those countries. The capital account surplus increased strongly in 1995 (by US\$160 million compared with 1994), reflecting short-term capital inflows and larger official external borrowing. An Association Agreement with the European Union was signed in June 1995, and accession negotiations with the World Trade Organization commenced in the fall of 1995. The real exchange rate appreciated by 8 percent in 1995; nevertheless, wages in Lithuania remain low in comparison with other countries at a similar stage of transition.

Fiscal policy. Restrained fiscal policy has been a central element of Lithuania's stabilization policies. Faced with a sharp decline in budgetary revenue, from 44 percent of GDP in 1990 to 24 1/2 percent of GDP in 1994, 1/ the General Government progressively cut expenditure. The fiscal balance was kept in surplus in 1991-1992, but subsequently moved into deficit, reaching 4 percent of GDP by 1994. The trend in revenue turned around in 1995, when revenue as a share of GDP increased for the first time since independence was regained. Combined with a further reduction in the expenditure-to-GDP ratio, the fiscal deficit was reduced to 3 1/2 percent of GDP in 1995. As the currency board arrangement precludes central bank financing of government operations, weekly treasury bill auctions were introduced in mid-1994. With a sharp decrease in foreign budgetary support, domestic financing of the government borrowing requirement moved from minus

1/ IMF Staff Country Report No. 95/82 (Chapter III) contains an analysis of the factors behind this revenue decline.

4 percent of GDP in 1993 to 2 percent in 1994. In 1995, the reduction in the fiscal deficit, combined with increased foreign financing, led to a reduction in government domestic financing to 1/2 percent of GDP.

Monetary policy and developments. Since April 1994, monetary policy in Lithuania has been prescribed by the currency board arrangement. This arrangement requires full foreign exchange coverage in gross terms for reserve money and other litas-denominated liabilities of the Bank of Lithuania. 1/ The central bank's operations are basically limited to buying and selling foreign exchange against litas at a fixed exchange rate (since the currency board arrangement started to operate, the exchange rate has been fixed at Llt 4=US\$1). In effect, the changes in reserve money normally equal the changes in foreign exchange reserves. The exchange rate of the litas under the currency board arrangement was fixed at Llt 4=US\$1 by the Government in consultation with the Bank of Lithuania prior to the start of operations of the currency board. The power to change the exchange rate was transferred to the Bank of Lithuania (in consultation with the Government) by an amendment of the Litas Stability Law in June 1994.

Extension of central bank credit under the currency board arrangement is limited to the amount of foreign exchange reserves in excess of those needed to provide full backing of base money. The Bank of Lithuania has generally refrained from such lending in order to retain loanable funds in reserve for acting as a lender of last resort. This function came into play in late 1995, in the aftermath of the banking crisis (see below), when the Bank of Lithuania provided liquidity by extending credits, in addition to relaxing the enforcement of reserve requirements. At the same time, government expenditure were cut in the opening months of 1996, and the fiscal stance was tightened considerably. This mix of monetary relaxation and fiscal tightening helped weather the crisis; financial conditions stabilized and the currency board was preserved.

Banking sector. In the initial stages of transition, Lithuania witnessed a sharp increase in the number of financial institutions, which was facilitated by low minimum capital requirements and lax licensing. At the beginning of 1994, there were 28 banks operating, falling into three categories: (i) 13 smaller private banks, accounting for 3 percent of deposits (all of which by March 1996 had been placed under bankruptcy proceedings or slated for liquidation); (ii) 12 larger or medium-sized private banks (the category of banks most affected by the December 1995 banking crisis); and (iii) 3 state-controlled banks (State Commercial Bank, Agricultural Bank, and Savings Bank), accounting for about half of deposits (these banks enjoy full deposit protection under the Civil Code). At present, 11 banks remain fully operative.

1/ In reality, the coverage has been in excess of 100 percent; in 1995, the coverage was some 140 percent.

The underlying problems in the banking sector--substantial nonperforming loans, nontransparent accounting practices, and lax enhancement of prudential regulations--had been recognized for some time, but limited progress had been made in addressing them. Besides the closure of the smaller banks, a medium-sized bank had been put under administratorship in mid-1995 and the Government and the BoL had provided liquidity support to this bank. There also had been limited progress in enforcing compliance with the new prudential regulations based on the Commercial Bank Law passed in late 1994.

More forceful action to address the simmering banking problems were taken in late December 1995. Following completion of the on-site inspection of the largest private bank, which revealed a large proportion of nonperforming loans and lack of capital, the BoL suspended all operations of this bank. Subsequently, the operations of another medium-sized bank were suspended. The managements of the two banks were replaced by administrators. In addition, the operations of one more medium-sized bank were partly suspended in December. ^{1/} The banking problems, and the authorities' actions to deal with them, are discussed in more detail in Chapter III of this report.

Trade reform. Lithuania has undertaken substantial liberalization of its trade policy regime since regaining independence. Quantitative export restrictions have been almost totally eliminated. All quantitative import restrictions have been removed. Average import tariffs are presently quite low by international standards. While zero tariff rates apply to the majority of items, tariffs on agricultural products (and on certain other items such as alcohol) remain quite high, and the tariff structure remains highly dispersed. Also, the period since independence has been notable for the frequent changes in the trade policy regime, especially in import tariffs (Chapter V of this report provides an update on trade policy developments).

Energy sector. Lithuania's energy industry is designed to supply a region substantially larger than the country itself; at the same time, practically all primary energy is imported. The energy industry comprises the Ignalina nuclear power plant (which has two Chernobyl-type nuclear reactors), the Mažeikiai oil refinery (the only oil refinery in the Baltics), two hydro-power plants, one thermal-power plant, and four combined heat and power plants (so-called co-generation plants). Lithuania derives its energy mainly from liquid fuels, gas, and nuclear power. Electricity is produced chiefly by the Ignalina nuclear power plant. The energy sector has experienced severe financial difficulties as a result of low tariffs, weak revenue collection, and high production costs. Over the last two years, energy prices have been moved rapidly toward full cost recovery. However,

^{1/} To deal with hardship cases, the Government allowed depositors at the closed banks to withdraw up to Lit 1,000 each through a government-funded scheme set up at the Savings Bank.

weak bills collection and high production costs continue to undermine the sector's finances, which in turn have led to disruption in the supplies of primary energy from foreign suppliers.

Privatization. Lithuania rapidly carried out the first phase of privatization, largely based on a voucher scheme; this phase started in late 1991 and was essentially completed by mid-1995. The vouchers for the first phase of the privatization program were distributed to Lithuanian citizens in February 1991, in the form of "special investment accounts" at the Savings Bank. Individuals were permitted to match vouchers with cash for the purpose of purchasing state assets. About half of all state assets were privatized under the voucher scheme, notably, almost all housing and a large number of small- and medium-sized enterprises in the trading, public services, and industrial sectors. The privatization program has been implemented alongside initiatives to create independent, commercially oriented businesses on the basis of the state-owned enterprises. To this end, the enterprises have been given financial autonomy, direct subsidies have been phased out, and a Ministry of Trade and Industry has been established.

The second phase of privatization will be based primarily on cash sales of state assets, and is currently expected to commence in mid-1996. The start of cash privatization has been delayed by the need to establish the independent Privatization Agency and amend the Stock Exchange Law to allow direct sales by this Agency (the law had prohibited sales of shares outside the Stock Exchange). The Government plans to include most of the remaining state enterprises in cash privatization, although there will be some exceptions. The list of enterprises to be privatized in 1996 was approved by the Government and announced in March 1996, and includes enterprises with total registered capital of Llt 290 million, or one tenth of registered capital of assets currently slated for privatization. The list includes 39 percent of the shares in Mažeikiai oil refinery, which would bring its privately owned share to 49 percent. Foreign and domestic investors will be permitted to participate on an equal footing in the cash-based privatization program.

The constitutional ban on foreign land ownership in Lithuania has been an obstacle to foreign direct investment and was also a key issue in the negotiation of the EU Association Agreement signed in mid-1995. A constitutional amendment to lift this ban is expected to receive its final parliamentary reading in June 1996, paving the way for the ratification of the EU Association Agreement..

Legal reform. Since independence was regained, the Government has been working on a complete overhaul of the legal system, including harmonization with EU legislation. The main legislative areas that currently are being addressed relate to (besides foreign land ownership): bankruptcy and competition legislation; property registers for loan collateral; international accounting standards; and simplification and non-arbitrary application of business regulations, including licensing requirements for

businesses. The Government has supplemented the efforts to introduce an appropriate legal framework by measures to ensure that government institutions enforce the laws; in particular, it has initiated an anti-corruption plan for 1996-97. This plan was approved by Parliament in November 1995, and has four elements: (i) organizational measures such as improved monitoring of corruption cases; (ii) revision of legislation to reduce the scope for corruption; (iii) strengthening of the capacity for investigation and prosecution of economic crimes; and (iv) general measures to prevent corruption, such as increasing the salaries of civil servants and liberalizing commercial activities.

The role of the International Monetary Fund. During the transition period, the International Monetary Fund has supported Lithuania through technical and financial assistance. A first stand-by arrangement (SBA) with the Fund, covering the period July 1992-June 1993 and in an amount of SDR 57 million, was approved by the Fund's Executive Board in late 1992. A follow-up SBA, covering July 1993-December 1994 and in an amount of SDR 26 million, was approved in late 1993. ^{1/} In addition, the Fund approved purchases under the Systemic Transformation Facility (STF) in October 1993 and April 1994, both in an amount of SDR 26 million. The current program, covering October 1993 to September 1997, is supported by an arrangement under the extended Fund facility (EFF) in an amount of SDR 135 million. Finally, the Fund has provided technical assistance on a wide range of issues, covering statistics, budgetary management, and monetary policy.

^{1/} Only SDR 5 million was drawn under the second SBA, as it was replaced before its expiration by the present arrangement.

II. Developments Under the Currency Board Arrangement: The Record and Policy Issues

1. Introduction

After a period of operating a conventional central bank, Lithuania adopted a currency board arrangement in April 1994. ^{1/} The establishment of a currency board entails a change in the institutional framework for monetary policy, with the explicit intention of enhancing the credibility of the authorities' anti-inflation policies. Under a currency board, the monetary authority's activities are essentially limited to the buying and selling of foreign exchange at a fixed exchange rate without limitations as regards amounts, thus maintaining a given foreign exchange coverage of the domestic currency issued. This arrangement implies that the scope for monetary policy maneuver is reduced. In effect, the authorities attempt to enhance their credibility, beyond that stemming from a conventional fixed exchange rate policy, by giving up policy instruments that could be used for expansionary purposes (such as central bank credit extension and open market operations); thus, they forego the possibility of "monetary surprises."

This chapter takes stock of the empirical evidence on the operation of Lithuania's currency board from the two years since it was adopted, in order to assess the extent to which the currency board has helped enhance policy credibility and reduce inflation. This assessment is complicated by the shifting influence of factors other than the currency board per se during this period; some of these factors may be relatively easily identified (for instance, the energy sector's financing difficulties in 1994/95 and the banking crisis in late 1995/early 1996), while others are less obvious. The chapter first looks at the evidence regarding "policy credibility" (section 2); the conclusion that emerges is that the currency board indeed appears to have improved credibility, but that this credibility remains fragile and might be easily undermined by any actions to alter elements of the currency board or by other economic policy actions that are perceived by markets to undermine stability. The discussion then turns to developments in inflation over the last two years (section 3). While inflation has been on a declining trend, it still runs at 2-3 percent per month. The empirical analysis suggests that the main factors contributing to the continued inflation have been relative price adjustments ^{2/} in the face of downward price rigidity and a catch-up from the initial exchange rate undervaluation when the currency board was established; as could be expected, monetary policy has played little or no role in propagating inflation during this

^{1/} Camard (1996) describes the process leading up to the establishment of the currency board arrangement.

^{2/} Including for administered prices, energy prices being an important component.

period. 1/ Continuous inflation at 2-3 percent per month raises questions about the credibility--and indeed the sustainability--of the currency board arrangement over time; the final section of this chapter (section 4) reviews the evidence concerning Lithuania's external competitiveness during the currency board period. While Lithuania's competitiveness has been substantially eroded over the last two years, it appears to remain adequate, as evidenced by Lithuania's low relative wages in U.S. dollar terms and low level of relative consumer prices, as well as its sound balance of payments position.

2. Economic policy credibility

Following a brief review of basic issues (definition of "credibility;" why credibility is desirable; how the design of the currency board might affect credibility), this section reviews empirical evidence on whether the currency board arrangement has helped improve the Lithuanian authorities' economic policy credibility.

a. General considerations

Economic policy credibility is somewhat loosely thought of as the perceived likelihood that the authorities will follow through on their policy announcements. The importance of policy credibility is well documented in the economic literature. 2/ It is generally thought that a higher degree of credibility would allow a given reduction in the rate of inflation with a smaller loss of output and lower unemployment. The channels could be the financial markets (through the impact on interest rates) or the labor market (through the effect on the wage-setting process under forward-looking expectations). While it is impossible to measure credibility directly, it might nevertheless be possible to observe the effects of credibility (or lack thereof). Specifically, in a currency board context, credibility could be reflected in the perceived probability that the exchange rate peg will be maintained; this probability in turn would be reflected in interest rate developments and in the effects of interest rate developments on the broader economy. This is the approach of this chapter. 3/

1/ This, of course, is not to say that inflation in principle could not have been lower with an active, contractionary monetary policy under a conventional central bank system. On the other hand, a conventional central bank might have been more susceptible to pressures for an expansionary monetary policy, and might have engendered less credibility, with a resulting higher inflation.

2/ See, for instance, Andersen (1989), Andersen and Risager (1991), and Calvo (1989).

3/ Andersen and Risager (1991) discuss the role of credibility for the effects of a change in exchange rate policy, with the effects on the real economy being transmitted through the wage-setting process.

As noted above, the introduction of a currency board arrangement seeks to enhance the credibility of the authorities' anti-inflation policy. The extent to which this succeeds depends, besides the design of the currency board arrangement itself, on a number of aspects of the overall economy. 1/ The specific features of the currency board arrangement--and how it is operated--are important, as they will influence the public perception of the authorities' commitment to the fixed exchange rate and to the arrangement itself. The following features would be expected to influence credibility:

♦ the level of the nominal exchange rate peg; i.e., how closely the exchange rate is in line with the equilibrium rate. If the actual level of the exchange rate peg is perceived to be substantially out of line with the equilibrium exchange rate, this would result in a larger interest rate differential than if a "more correct" level is chosen. 2/ Although a currency board arrangement typically starts out with an exchange rate in line with, or more depreciated than, the equilibrium rate, the combination of a fixed nominal rate and continuing inflation has the potential to undermine competitiveness--and thereby the credibility of the exchange rate peg--over time (c.f., section 4 of this chapter);

♦ how long the arrangement has been in place. For each period that the currency board arrangement is maintained at the announced exchange rate peg, the perceived probability that it will remain unchanged in the next period would be expected to increase, cet. par. 3/ This effect might be strengthened in cases where the authorities, in order to keep the currency board in place, are taking supporting measures, such as fiscal tightening;

♦ the type of administrative actions that would be required to change the exchange rate peg (or the currency board arrangement as such). It could be argued that the highest degree of credibility would be obtained if the peg were written into the law and could only be changed by Parliament; less credibility would be gained if the Government had this power, and perhaps even less if it fell to the central bank to make decisions on the exchange rate (as is the case in Lithuania). However, the degree of credibility would also depend on the Parliament's susceptibility to political pressures, and the degree of central bank independence. The institutional design of the currency board could also have an effect on

1/ Such aspects include the soundness of the banking system, the institutional set-up (degree of central bank independence; power of the legislature; strength of interest groups), the extent of price and wage flexibility, the Government's commitment and ability to pursue fiscal restraint, external competitiveness, and political stability.

2/ It is also possible that the probability that the exchange rate would be maintained would be lower the larger the deviation between the equilibrium and the actual exchange rate.

3/ Andersen and Risager (1991) illustrate how credibility is built up gradually over several periods, in the context of a model describing a policy game under incomplete information.

credibility; for instance, the representation in its governing bodies might affect the susceptibility to political pressures; 1/

♦ the extent of foreign exchange coverage for the local currency issued. The larger this coverage, the greater the ability of the monetary authority to honor its obligations. In Lithuania, the coverage calculated on the basis of gross international reserves was in the order of 140 percent in 1995; if the Bank of Lithuania's foreign exchange liabilities are netted out, the coverage was some 75 percent. A lower coverage on a net than on a gross basis is less of a concern to the extent that the liabilities are longer term and can be easily rolled over. In the case of Lithuania, the lower coverage on a net basis mainly reflects liabilities to the Fund. A closely related factor affecting credibility is the monetary authorities' investment policy for its international reserves, specifically--given the currency portfolio--the extent to which international exchange rate movements could affect the foreign exchange coverage for domestic currency liabilities; 2/ and

♦ the scope for central bank lending and other discretionary liquidity injection (such as reduction in reserve requirements). A greater scope for liquidity injection could improve or worsen policy credibility, depending on the circumstances. On the one hand, a greater scope for such lending implies that the monetary authority has more room to deal with bank failures as a lender of last resort. On the other hand, a greater scope means more room for discretion, which goes against the grain of the currency board arrangement.

b. The Lithuanian experience

Some of the specific design features of the Lithuanian currency board arrangement might not suggest that the arrangement would engender large credibility gains, for instance, the relatively limited administrative action needed to change the exchange rate peg. Pointing in the other direction are the relatively high foreign reserve backing of the domestic currency issue, as well as the continuing competitiveness of the Lithuanian economy, and the fact that the currency board has been kept in place for two years through at least two periods of major strains. Indeed, developments in economic variables, including in interest rates and real economic variables, suggest that credibility has improved.

If the Lithuanian authorities' attempt to increase their policy credibility by establishing the currency board arrangement has been successful (and abstracting from the effects of other factors), one would

1/ See Hanke and Schuler (1994).

2/ This consideration suggests that the foreign reserves held to back the domestic-currency issue should be invested predominantly in the currency to which the local currency is pegged.

expect credibility to increase over time. As a result, certain trends would be observed: 1/

♦ declining domestic nominal interest rates towards international levels, and initially high ex post interest rates in U.S. dollar terms (as the exchange rate is kept stable, while credibility starts out from a relatively low level), followed by declining rates as credibility increases;

♦ increasing the demand for domestic monetary assets of the public which, given the currency board set-up, would be reflected in increases in foreign reserves;

♦ initially negative effects on economic activity, followed by a recovery of output, combined with a deceleration in inflation, diversification of trade toward markets with more stable exchange rate relationship vis-à-vis the litas (i.e., western markets), and increased foreign direct investment.

Clearly, in Lithuania in the two years since April 1994, factors other than the introduction of a currency board arrangement per se, and its effect on inflation, have affected the variables noted above. Over time, the broad-based reform and stabilization program is bound to have had implications, including on perceived credit and default risk, although these effects are hard to discern. In illustrating how other factors affect credibility, two episodes--one in late 1994/early 1995 and the other in late 1995/early 1996--stand out. In the first instance, the currency board came under pressure because of certain actions taken by the authorities to raise financing for the energy companies and enable them to import fuel inputs during the winter. 2/ In the second instance, the pressures arose following the closure by the Government of some major commercial banks in December 1995 (see Chapter III), and thus may have reflected a heightened awareness of the weaknesses of the banking system, rather than doubts about the authorities' commitment to the currency board as such. During the more recent episode, the problems were exacerbated by political uncertainty with the impending change of Government in early 1996. In both cases, the pressures occurred amidst calls for a depreciation of the litas, and led to temporary capital outflows and interest rate hikes.

Abstracting from these two episodes, developments since the currency board arrangement was introduced suggest that the arrangement has been successful in enhancing the credibility of the authorities' disinflation

1/ Hansson and Sachs (1994) discuss these and other factors by comparing the experiences of Estonia, Latvia, and Lithuania up to early 1994.

2/ These actions were: (i) the inclusion of treasury bills purchased in one auction in the definition of required reserves to ease the Government's financing constraint; (ii) the exemption of one bank from the reserve requirement to allow this bank to extend credit to an energy company; and (iii) the pledging of central bank foreign exchange reserves at a foreign bank as collateral for lending by this bank to the energy companies.

effort. This is evident in the lower level of interest rates that has prevailed. 1/ In the second half of 1994, after the currency board had been in operation for about six months, both nominal deposit and lending interest rates dropped (Chart 1). Deposit rates declined from about 55 percent in March 1994 to about 20 percent at the end of year, and have remained at that level, and lending rates followed a similar pattern, declining from 70 percent to 25-30 percent. The interest rates on treasury bills have, however, been more sensitive to pressures on the currency board; hence, while they also have been on a declining trend, this trend was temporarily interrupted during the episodes of late 1994 and late 1995. Similarly, following sharp variations during 1993, domestic ex-post interest rates measured in U.S. dollar terms declined in the second half of 1994, and stayed a little above 20 percent in the subsequent period (Chart 2). In domestic currency terms, real ex-post deposit rates have been close to zero since late 1994, while real lending rates have been substantially positive, although they have exhibited a significant decline following the establishment of the currency board.

The lower interest rates have coincided with a strong expansion in monetary assets of the public that has been reflected in a similar increase in foreign reserves. However, this increase in monetary assets has not been associated with any clear trend toward increased monetization; monetization declined in early 1996 in the wake of the banking crisis (Chart 3).

As regards real-sector developments under the currency board, the output decline--which in Lithuania had been among the most severe in the region--came to an end in 1994 (Chart 4). Inflation in Lithuania had already been brought down to a moderate level, i.e., a level which is generally considered not to have major negative effects on output, before the currency board was established; 2/ however, a further decline in inflation below 2-3 percent monthly rate has proven elusive. As could be expected, the reorientation of international trade towards western markets has continued since the establishment of the currency board (Chart 5). While the stable exchange rate relationship of the litas with those markets may have contributed to this continuing trend, undoubtedly, it also has been helped by the more open trade regime, trade agreements, and the continued after-effects of the dismantling of the previous directed trade system. In contrast to the experience in some neighboring countries, foreign direct investment into Lithuania has been relatively modest (about US\$60 million in 1994 and 1996). However, the slow response of foreign investment might be more closely associated with delays in starting cash privatization and clear

1/ Considering the embryonic state of financial markets in Lithuania, care should be taken when interpreting short-term movements in interest rates.

2/ Bruno and Easterly (1995) suggest that this inflation level is 40 percent per annum, or about 3 percent per month.

CHART 1
LITHUANIA
NOMINAL INTEREST RATES
(Monthly return)

Source: Lithuanian authorities.

CHART 2
LITHUANIA
REAL INTEREST RATES
(Monthly return)

Source: Lithuanian authorities.

CHART 3
LITHUANIA
MONETIZATION AND FOREIGN EXCHANGE FLOWS

Source: Lithuanian authorities.

CHART 4
LITHUANIA
GROWTH AND INFLATION

Source: EUH database.

CHART 5
LITHUANIA
EXTERNAL TRADE INDICATORS

1993

Export shares

1995

1993

Import shares

1995

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policy signals regarding foreign investment by the authorities 1/ rather than exchange rate credibility as such.

3. Inflation

Inflation in Lithuania has declined sharply since the currency board was put in effect, but continues to run at a relatively high rate (Chart 6). The present section reviews overall developments in inflation, and discusses possible sources of inflation (undervaluation of the nominal exchange rate, relative price adjustments, monetary aspects, wage pressures, and differential productivity growth in the tradable and non-tradable goods sector).

a. Overall developments

In April 1996, the 12-monthly change in the consumer price index was 31 percent, compared with 45 percent in April 1995 and 79 percent in April 1994. Despite great month-to-month variability, in part, monthly inflation rates have continued to decline gradually since the establishment of the currency board (Chart 7).

Inflation measured by the producer prices index (PPI) has been consistently lower than consumer price inflation, but has exhibited the same downward trend. The 12-monthly change in the PPI was 14 percent in March 1996, down from 39 percent in March 1995 and 79 percent in March 1994.

b. Sources of inflation

Initial undervaluation of the exchange rate. There is empirical evidence that the nominal exchange rate under the currency board was fixed at a depreciated level compared with the equilibrium rate, and that this has contributed to inflation. 2/ Findings on purchasing power parity (PPP) made by the Conference of European Statisticians 3/ suggest that the 1993 price level prevailing in Lithuania was 18 percent of that prevailing in Austria. Taking into account nominal exchange rate movements and differential inflation rates between 1993 and April 1994, this implies that Lithuanian prices stood at about 30 percent of Austrian prices at the time when the currency board was established. These findings, coupled with the assumption that the PPP exchange rate was not too far removed from the

1/ See World Bank (1995) for a survey of factors affecting foreign investment in Lithuania.

2/ However, this does not necessarily imply that the initial rate at which the litas was pegged was unjustified, as it ensured the competitiveness of Lithuanian businesses as well as the credibility of the fixed exchange rate regime in a situation of considerable uncertainty about the equilibrium exchange rate.

3/ Conference of European Statisticians, European Comparison Program: Report on the Central and Eastern European Comparison, Vienna Consultation 1995.

equilibrium exchange rate, point to a substantial initial undervaluation of the Litas.

An exchange rate fixed below its equilibrium level puts upward pressure on prices in an open economy, as domestic prices tend to adjust to world market prices. In particular, those products which are most severely underpriced would be expected to be subject to the strongest inflationary pressures. The data on Lithuania exhibit such a pattern. Table 1 lists the March 1994 to March 1996 change in the price for 26 categories of products and their respective March 1994 price level relative to that prevailing in Austria. There is a strong negative correlation between inflation rates and initial price level; the coefficient of correlation is -0.46 (and the associated t-value indicates significance.)

Relative price adjustments. Relative prices in Lithuania exhibit a high degree of variability, which is strongly positively correlated with the rate of inflation. There is tentative empirical evidence that causality runs from relative price variability to inflation rather than vice versa. Regressing inflation rates on relative price variability yields a significant positive correlation, independent of whether one-month, 3-month, or 12-month inflation is used. Chart 8 shows the development over time in inflation rates and relative price variability (which is measured as the weighted sum of the absolute deviations of inflation rates of CPI components from CPI inflation). There are at least two alternative explanations for this correlation, which imply a different direction of causality between relative price variability and inflation. The evidence from the data supports indirectly the view that relative price variability has contributed to inflation. According to this interpretation, relative prices in Lithuania were initially out of line with relative prices abroad; in the process of integration with the world economy, relative prices in Lithuania moved toward those prevailing on world markets and, if prices are rigid downwards, this adjustment process would have resulted in an increase in the general price level. It is conceivable, however, that relative price variability may have been a by-product of inflation, arising from the fact that the adjustment of individual prices is not perfectly synchronized in time. A testable implication of this interpretation is that the power of inflation to explain relative price variability would be relatively higher for short-run inflation than for long-run inflation. However, the data on Lithuania suggest the opposite: annual inflation is most closely correlated with relative price variability; three-month inflation is less closely correlated with relative price variability; and one-month inflation exhibits the weakest correlation (the associated coefficients of correlation are 0.97, 0.85, and 0.67, respectively).

CHART 6
LITHUANIA
INFLATION IN CONSUMER PRICES

Source: Lithuanian authorities.

CHART 7
LITHUANIA
INFLATION AND TREND INFLATION

Sources: Lithuanian authorities; and Fund staff estimates.

- 14b -

CHART 8
LITHUANIA
INFLATION AND RELATIVE PRICE VARIABILITY

Sources: Lithuanian authorities; and Fund staff estimates.

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Table 1. Lithuania: Inflation and Undervaluation

	Price change between March 1994 and March 1996	Lithuanian price relative to Austrian price in March 1994
	<u>(In percent)</u>	
Bread, cereal products	97	18
Meat, poultry	35	35
Fish, fish products	24	34
Dairy products, cheese, eggs	118	17
Butter, oil, fats	72	50
Other food products	64	51
Soft beverages	63	59
Alcoholic beverages	80	52
Tobacco products	46	14
Clothes, fabrics	69	25
Footwear	70	76
Furniture	50	27
Household textiles	87	32
Domestic appliances	28	46
Dwelling expenses	129	5
Energy, fuel	161	13
Medical care, health services	48	15
Private transport	54	46
Public transport	119	14
Communication services	129	6
Education, recreation, entertainment	91	26
Goods for recreation	47	68
Cultural and leisure services	52	33
Printed media	227	18
Education	74	18
Other goods and services	83	7

Source: Fund staff estimates.

Monetary policy. Since the establishment of the currency board, the institutional setup of the central bank has rendered it quite unlikely that monetary factors have made an independent contribution to inflation. The currency board leaves no room for expansionary monetary policy. Monetary policy is essentially passive, and limited to the BoL exchanging the anchor currency at the fixed rate against domestic currency upon demand. Thus, there is limited room for extending central bank credit. In actual fact, monetary aggregates have moved broadly in parallel with inflation.

Evidence from the recent banking crisis and a period of reduced confidence in the domestic currency suggests that money supply adjusts readily to money demand without any noticeable effects on inflation. Chart 9 depicts the development of reserve money, broad money, and the CPI since the establishment of the currency board arrangement. Two episodes of contraction in monetary aggregates can be observed, in late 1994 and late 1995. Between November 1994 and February 1995 reserve money declined by over 9 percent amidst devaluation rumors. When problems in the banking sector emerged towards end-1995, reserve money fell by over 20 percent between December 1995 and March 1996, following a freeze on deposits affecting about 20 percent of all commercial bank deposits were frozen. In both cases, the rate of inflation was unaffected.

Wage pressures. There is little evidence that increases of nominal wages have contributed to inflation in Lithuania. Real wages experienced a sharp drop in 1992 and began to recover only in mid-1993. Still, at the time when the currency board was introduced, real wages stood at little over 50 percent of their level in January 1992. Since April 1994 nominal wages have grown broadly at the same rate as consumer prices (Chart 10). The nominal wage growth in excess of inflation over the course of 1995 was accompanied by decelerating inflation.

Evidence on sectoral wage and price developments also fails to support the wage-push hypothesis of inflation. Table 2 shows the wage and price inflation that has occurred since the introduction of the currency board. They are negatively correlated with a coefficient of correlation of -0.325. Although the limited data availability requires caution in interpreting this result, it is possible that the more a sector is in trouble the more it increases prices and the less it increases wages relative to the average.

Differential productivity growth. The view that the relatively high inflation in Lithuania is partly due to higher productivity growth in the tradeable goods sector relative to the non-tradeable goods sector (the "Balassa-Samuelson effect" 1/) is consistent with the evidence. If this view is correct, one would expect prices for services to grow more quickly than prices of traded goods. Concerning the development of major components

1/ See A. Richards and G. Tersman, "Growth, Nontradables, and Price Convergence in the Baltics," IMF Working Paper 95/45, International Monetary Fund, Washington, D.C., April 1995 for an application to the Baltic countries.

CHART 9
LITHUANIA
MONEY AND PRICES

Source: Lithuanian authorities.

- 16a -

CHART 10
LITHUANIA
INFLATION AND WAGES

Table 2. Lithuania: Price and Wage Inflation by Sector

	Price inflation March 1994 – March 1996	Wage inflation March 1994 – March 1996
	<u>(In percent)</u>	
Agriculture and food processing	95.0	89.5
Manufacturing of textiles	69.0	68.6
Publishing and printing	80.2	227.4
Electricity	11.8	149.3
Steam and water	58.0	330.1
Hotels and restaurants	8.0	150.0
Transportation	88.8	76.8
Communications	140.7	128.5
Insurance	107.2	0.0

Sources: Lithuanian authorities; and Fund staff estimates

of the consumer price index (CPI), prices for services have grown above average since the introduction of the currency board--at an annual rate of 37 percent while the increase in food prices has been relatively modest (27 percent), and prices of non-food products have grown at the slowest pace (24 percent) (Chart 11). However, energy prices have increased the most--at an annual rate of 78 percent.

4. External competitiveness

While Lithuania's exchange rate was initially undervalued in April 1994 (as discussed above), this margin has been at least partly dissipated by inflation. If the equilibrium exchange rate remained unchanged over the medium term, Lithuania would suffer a loss of competitiveness if the high relative inflation continued after the initial undervaluation had been eliminated. High relative inflation could be partly or wholly mitigated by the Balassa-Samuelson effect. The reverse is possible, however, if productivity growth were more rapid in the nontradable sector.

a. Methods for assessing competitiveness

There are three standard methods for assessing implications of trends in the real exchange rate for international competitiveness: (i) comparison of the actual exchange rate with the purchasing power parity (PPP) exchange rate; (ii) comparison of the real exchange rate with its level in some base period during which equilibrium is believed to have prevailed; and (iii) comparison of the real exchange rate with its equilibrium rate based on econometric estimation of a macroeconomic model. ^{1/} These approaches are not well-suited for transition economies such as Lithuania. The first approach is infeasible due to lack of data on PPP exchange rates. It is not possible to implement the second approach for Lithuania since there is no consensus as to a basis period during which the exchange rate is target to have been in equilibrium. Finally, the macroeconomic modeling approach assumes a stable economic structure and requires reliable time-series data, both of which are lacking. These problems have led analysts to adopt alternative approaches to assessing implications of trends in real exchange rates for external competitiveness in transition economies.

^{1/} P. Clark, L. Bartolini, T. Bayoumi, and S. Symansky, "Exchange Rates and Economic Fundamentals: A Framework for Analysis," Occasional Paper 115, International Monetary Fund, Washington, DC, December 1994.

CHART 11
LITHUANIA
CPI BY COMPONENT

Sources: Lithuanian authorities; and Fund staff estimates.

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b. Real exchange rate indexes and indirect indicators

The first approach has been to look at a variety of indicators, including alternative measures of the real exchange rate and other measures of external performance. ^{1/} Several alternative measures of the real exchange rate have been used to assess external competitiveness, including: (i) the real effective exchange rate index based on consumer price indexes (CPIs); (ii) relative unit labor costs in U.S. dollar terms; and (iii) U.S. dollar wage rates (Charts 12 and 13).

While there is a trend real appreciation evident in each of the indexes, it is impossible to determine to what extent the initial undervaluation has been dissipated and how much the present real exchange rate may be below its equilibrium value. Often, real effective exchange rate measures based on price indexes that include prices of both tradables and nontradables, such as CPIs or GDP deflators, tend to show more rapid real appreciation than other measures if productivity growth in tradables exceeds productivity growth in nontradables.

It is tempting to conclude from a comparison of U.S. dollar wages in Lithuania, Estonia, and Latvia, as well as other Central and Eastern European countries, that Lithuania remains internationally competitive. Indeed, as shown by indirect indicators below, its external performance remains favorable (Chart 14). While the U.S. dollar wage comparisons are consistent with such a view, they should be judged with caution since Lithuanian wage measures capture only a portion of total labor remuneration, and because no adjustment has been made for productivity differences across countries.

As regards other indirect indicators of competitiveness, exports have grown rapidly, the trade deficit has narrowed in relation to GDP, and substantial international reserves have been accumulated. It is important to stress that many factors have contributed to these developments. Regarding the trade balance, this has been influenced to an important extent by reductions in energy supplies from Russia and the continuing restructuring of Lithuania's agricultural sector. Foreign direct investment in Lithuania has been influenced by a variety of factors, including changes in the trade regime, credibility of macroeconomic policy, developments in the banking sector, and conditions for foreign investment including the prohibition of foreign land ownership; however, there is no indication that inflows have been dampened by an overvalued exchange rate. Foreign reserves have been heavily influenced by the manner in which the currency board arrangement has been operated and by conditions in the banking sector.

^{1/} T.O. Saavalainen, "Stabilization in the Baltic Countries: A Comparative Analysis," IMF Working Paper WP/95/44, International Monetary Fund, Washington, DC, April 1995, presents indirect indicators of external competitiveness for each of the Baltics, including the trade balance as a percent of GDP, exports to industrial countries, foreign direct investment, and official foreign reserves.

Nevertheless, these indirect indicators clearly show that the real appreciation of the litas has not been associated with a deterioration in Lithuania's external position.

c. Equilibrium U.S. dollar wage rates

A second approach used to assess external competitiveness of transition economies, ^{1/} involves the economic estimates equilibrium real exchange rates econometrically, based upon a model that starts from the Balassa-Samuelson framework and incorporates additional factors suggested by the empirical literature on the determinants of cross-country differences in economic growth.

Specifically, the Balassa-Samuelson model implies that the U.S. dollar wage rate is a function of total factor productivity in the tradable sector, the capital/labor ratio, and world prices. Since direct data are unavailable, productivity is captured by factors identified in the literature on endogenous growth based upon cross-country regressions, such as human capital (measured by educational attainment), the size of the agricultural sector in relation to GDP, and the size of government relative to GDP. The capital/labor ratio is measured by per capita income. Country-specific effects are included in the regression. Cross-sectional data were used for 52 countries (but not the Baltics) for 1970, 1975, 1980, 1985, and 1990, to estimate the regression equation econometrically. Using the fitted value from this regression equation, "predicted" U.S. dollar wage rates were formed for each country in the sample.

The predicted wage can be formed either including the country-specific effects or not; these differ in their interpretation. To predict the U.S. dollar wage rate at the outset of the transition period, Halpern and Wyplosz include the country-specific effects, which capture mainly the nature of the political and economic policy regime. To predict the U.S. dollar wage that would emerge under "normal" conditions, they omit the country-specific effects, referring to these as long-run equilibrium real exchange rates, and compare actual U.S. dollar wage rates with these "equilibrium" rates to assess the extent of undervaluation. They find some cases in which there is evidence of substantial undervaluation on this basis (e.g., in Czechoslovakia, Hungary, and Poland, the actual wage was only 30 percent to 80 percent of the "equilibrium" wage).

While suggestive, these results should be interpreted with caution. In addition to the usual caveats regarding model specification and measurement errors, the interpretation of the fitted value of the U.S. dollar wage rate (omitting the country-specific effect) is problematic. Since many OECD and other non-transition economies are included in the sample, the fitted wage for a transition economy such as Lithuania corresponds closely to the wage that would prevail in an OECD country that had the same levels of productivity and human capital as Lithuania. As such, the gap between the

^{1/} Employed by Halpern and Wyplosz (1995).

CHART 12
LITHUANIA
EFFECTIVE EXCHANGE RATES (1/93-3/96)
[Trade Weights]

Sources: IMF, International Financial Statistics, staff reports on Belarus, Lithuania, the Russian Federation, Ukraine, and staff estimates.
1/ Increase implies an appreciation.
2/ Baltics, Russia, and other FSU republics.

CHART 13
LITHUANIA
AVERAGE MONTHLY WAGES
(In U.S. dollars)

- 20b -

CHART 14
LITHUANIA
INDIRECT INDICATORS OF COMPETITIVENESS

Source: Lithuanian authorities and Fund staff estimates.

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fitted and actual wage is a residual that captures the whole range of factors that differentiate Lithuania from OECD countries. Bearing in mind the persistence of differences in real incomes even across OECD countries, if Lithuania allowed its real exchange rate to appreciate to the extent suggested by these calculations, even over the medium term, it might experience a significant loss in external competitiveness.

The analysis in the preceding section indicated that the correction for the initial undervaluation of the exchange rate and relative price adjustment have been the main sources of inflation under the currency board arrangement. Against this background, the danger of an overshooting of the real exchange rate may not be imminent. Inflationary pressures stemming from an undervaluation of the exchange rate would tend to subside, once the real exchange rate approaches its equilibrium level. The current degree of undervaluation seems sufficient to allow for substantial additional relative price adjustment without giving rise to an overvalued real exchange rate. The steadily improving external position as indicated by export growth and reserve accumulation, supports this interpretation. Also, there have been few signs of the development of formal or informal indexation mechanisms or inflation mentality taking hold in Lithuania.

III. Banking Crisis and Policy Response

This chapter reviews the structure of the banking system and describes prudential regulations and deposit protection arrangements, as a backdrop to the discussion of the authorities' policy response to the banking crisis in late 1995.

The Lithuanian banking system is only a few years old, having developed over a period during which the needed legislation and supervision come into existence only gradually. The initial legislation and supervision contributed to a rapid growth in the number of banks. However, some of these banks were not soundly based. Weak lending skills, large amounts of politically based lending, and insider abuse lead to the formation of an undercapitalized banking system with large nonperforming loans. In the early stage of the transition to a market economy, high inflation eroded the real value of nonperforming loans, but with the decline in inflation, banks could no longer mask the strongly reduced cash flow from their nonperforming loans. When the authorities started to address the deteriorating situation in the banking sector by closing one large and two medium sized privately owned banks in late 1995, a banking crisis ensued. In cooperation with the Fund and the World Bank, the authorities are dealing with the bank crisis, as well as the more fundamental weaknesses of the banking system.

1. Structure of the banking system

As of end-March 1996, 15 banks were licensed in Lithuania, down from 28 in early 1994. The three biggest banks are all majority owned and controlled by the Government. In addition to the state-controlled banks, there are 12 privately owned banks, although the Government also owns a small proportion of the shares in some of them, including one former privately owned bank which has been taken over by the Government. Currently, 11 banks are fully operational.

The Lithuanian banking system is highly concentrated. The biggest bank is the State Savings Bank, which accounted for some 20 percent of all deposits as of end-March 1996. Three other banks are of roughly the same size; the State Agricultural Bank, the State Commercial Bank, and the Innovation Bank, each accounting for roughly 15 percent of all deposits. In total, these four banks account for two thirds of all deposits. Of the remaining 11 banks, five have deposit market shares between 5-9 percent, three have market shares of 2-4 percent, and the remaining three have market shares of less than one percent.

2. Prudential regulations

The enactment of a new Commercial Bank Law in late 1994 created the necessary conditions for implementing prudential requirements adequate for reliable supervision in a market-based economy. The new Commercial Bank Law gave expanded powers to the Bank of Lithuania to implement prudential regulations as well as to impose sanctions on banks that do not meet prudential standards.

One of the main problems facing the banks is undercapitalization. When the banks were founded, the required amount of capital was very low and subsequently, as the balance-sheets grew, reflecting in part the high inflation, capital did not increase proportionally. Tax laws also contributed towards eroding the capital base, as credit losses were not permitted to be deducted from profit before tax, forcing banks to pay taxes (and dividends) on possibly non-existent profits. As a result, banks have had difficulties in meeting the prudential standards set by the Bank of Lithuania, largely due to the shrinking capital base to which most of the regulatory ratios apply.

Since July 1, 1995 the minimum capital requirement has been ECU 1.9 million (US\$2.3 million). The amount will be raised to ECU 3.8 million (US\$4.6 million) on January 1, 1997, and to ECU 5 million (US\$6.1 million) on January 1, 1998, which is the amount required according to EU rules.

The banks are required to meet a capital adequacy ratio of 13 percent of risk-weighted assets, based on financial statements prepared under Lithuanian accounting standards. The Lithuanian rules differ from the Basle rules, which are the international standard, mainly in the treatment of losses which are not fully deductible from profits nor can be written off against the core capital of the bank. Thus, the capital adequacy ratio could differ substantially depending on the methodology, and it is not unlikely that a bank meeting the Lithuanian rules would have a negative capital if Basle rules were applied.

Connected lending (insider loans) may not exceed 10 percent of a bank's capital. The definition is narrower than international standards, as related- and controlled-party lending are not considered to be part of connected lending.

Maximum lending to one borrower (large exposure) may not exceed 30 percent of a bank's capital, which is somewhat higher than the 25 percent ratio commonly applied internationally. Moreover, the Lithuanian requirement is not calculated on a consolidated basis and does not include interbank credit.

Maximum positions in foreign currencies may not exceed 30 percent of a bank's capital and the open position for individual currencies may not exceed 20 percent, except for U.S. dollars. The liquidity ratio requires that the ratio of liquid assets to liabilities may not be less than 30 percent. These ratios are generally in line with ratios used internationally.

3. Deposit insurance

At present, a number of laws designed to protect depositors are in effect. On December 20, 1995 a law was passed, protecting individual depositors in private banks up to Llt 4,000 (US\$1,000); this law was to have become effective January 1, 1996, but has not yet been implemented. Initially only deposits in litai were to be protected but later (February 1, 1996) an amendment was passed including also domestic deposits in foreign currencies. Individuals' deposits in the state-controlled banks, which are fully protected under the Civil Code, are by end-1996 to be included under the same deposit protection scheme as depositors in the private banks. Furthermore, two more laws were passed when the bank crisis surfaced, the first protecting all creditors (not only depositors) in the two banks placed in moratorium (see below), and the other protecting depositors up to Llt 2,000 (US\$500) in banks that had already entered bankruptcy procedures by end-1995. These schemes have not been funded so far, effectively making the Government the insurer of the protected deposits.

4. The banking crisis

The Lithuanian banking system has been under increasing strain during the last two years. Since the beginning of 1994, 13 smaller banks, accounting for about 5 percent of all bank assets, have entered into bankruptcy proceedings. The first signals of deeper problems appeared during the summer of 1995, when a medium-sized bank (Aura Bank), facing liquidity problems, was put under administratorship and had to be supported financially by both the Government and the Bank of Lithuania. The banking problems became more serious during the fall of 1995: bank capital diminished; bank losses increased substantially; and, in order to keep another medium-sized bank from closing, the Government supported it with liquidity.

The fragility of the banking sector surfaced in late December 1995, when on-site inspections by the Bank of Lithuania revealed the insolvency of two privately owned banks (Innovation Bank and Litimpeks Bank). The operations of both banks were suspended and their activities were confined to collecting loans and other assets. Problems, however, spread also to another bank (Vakaru Bank), which had its operations partially suspended and was put under conservatorship. Altogether, these three banks account for 25 percent of all deposits. Moreover, published auditing reports for two of the state-controlled banks revealed that the banks made losses in 1995 and that they needed to be recapitalized in order to meet the capital adequacy ratio.

5. Bank restructuring plan

In response to a request from the authorities, a joint Fund/World Bank team visited Lithuania in January 1996 to work out a plan for restructuring the banking system as part of a proposed World Bank Structural Adjustment Loan. The authorities subsequently adopted a strategy to deal with the banking problems, which broadly was in line with this proposed plan. The

plan is intended as a once-for-all restructuring, and the overall principle is that individual banks (i.e., their owners and managers) are responsible for their own restructuring. Apart from cases of systemic risk, the Government's role would be to assure regulatory compliance, but not to keep banks operating. The use of government funds in the restructuring of banks would be contemplated only as a last resort option, and if such support is to be given, it would give the Government the same pro-rata portion of share capital and voting rights as new money provided by private contributors. Further, certain conditions were laid down in order to force banks to cut costs and operate in line with all prudential regulations. Specific changes in the Commercial Bank Law were also recommended, which would provide a new set of rules for the post-restructuring era. In summary, the restructuring plan as adopted--and which the authorities have begun to implement--includes the following key elements:

a. The three banks under moratorium (Innovation, Litimpeks, and Vakaru) would be restructured. This might initially involve government ownership, and the banks would later be privatized. 1/ Bad loans would be transferred to a special asset management company. Existing private shareholders would lose all their rights, as well as the full value of their shares;

b. The balance-sheets of the State Commercial Bank and the State Savings Bank 2/ would be cleaned up by a transfer of bad loans to the asset management company; the banks would receive an additional capital injection in cash from the Government; existing private shareholders would lose all their rights as well as the full value of their shares; later, these banks also would be privatized;

c. All other banks would be examined by external auditors who would have to submit a written statement, verifying that each bank is solvent and meets all prudential regulations. Banks found insolvent would immediately be closed and liquidated, while banks that did not meet all prudential standards would be given a respite of three months to achieve compliance;

d. The budgetary costs of implementing the plan would be financed by the issuance of special government bonds and cash transfers from the budget. No resources from the Bank of Lithuania would be used to finance the plan.

1/ Subsequently, owners of Litimpeks were able to provide additional capital and the bank was reopened without restructuring.

2/ The third state-controlled bank, the State Agricultural Bank, is not included in the plan as there already is a World Bank-supported restructuring plan in place for that bank.

IV. Medium-Term Fiscal Issues

Since the reform process got under way, Lithuania has made substantial progress in improving its budgetary position, including implementing a tight fiscal policy. In order to consolidate these efforts over the medium term, attention is now being paid to improving fiscal management in general by building the institutional framework for fiscal policy implementation, reforming the pension system, and developing an appropriate government borrowing strategy.

1. Institutional framework for fiscal policy implementation

Since independence was regained, the Ministry of Finance (MoF) has made considerable progress in transforming itself from a central planning institution, concerned with allocating funds and preparing and monitoring accounts, to a full-fledged MoF as in market economies. The MoF is now responsible for the Government's mobilization of resources and their disbursement, and has acquired considerable influence in the formulation of policies in these areas. Efforts began early on in the reform process to upgrade the MoF's system for budgetary management, and the Budget Department has been revamped to promote more active expenditure control. An essential part of these efforts is the introduction of a treasury system, which is now under way.

A Treasury Department was set up within the Ministry of Finance to take over the functions of expenditure control and cash management that were formerly performed by the monobank system. The project to establish a Treasury began in mid-1994 and has been supported by a coordinated program of technical assistance from, inter alia, the Fund and the Danish Government, each of which have provided long-term advisors. The implementation of a computerized treasury system, which is under preparation, is structured around an accrual based accounting system, drawing on the European model. Software for treasury transaction processing and accounting has been developed from a commercial accounting package, modified to meet the requirements of centralized revenue collection and payments. Development and testing of the software is nearing completion and hardware has been acquired and tested for the initial implementation of the system. Preparation for implementation by the Treasury Department and the spending ministries to be linked to the system is also in progress. The new system is expected to be operational for some ministries during 1996, and fully operational by mid-1997.

The treasury system, once it is established, will offer substantial benefits for expenditure control and fiscal management. Through its improved classification and direct payments to suppliers, the Treasury will exercise closer control over actual payments, will provide more accurate, timely, and analytical information on the Government's fiscal position, and will allow the Government to reduce the level of cash balances held in the banks to finance government programs. Areas which still require some additional attention for development are: (a) strengthening of cash-flow forecasting; (b) reducing spending authorizations in light of reduced

revenue of financing expectations; and (c) strengthening of internal audit. Information from the treasury system should, in turn, provide a better basis for budget planning and further strengthen expenditure management.

The Government is also developing methods to strengthen the budgeting process and to make the mechanism of collecting and consolidating fiscal data more frequent and comprehensive. Projections for tax receipts are unreliable, and the preparation and regular updating of medium-term macroeconomic and fiscal projections is essential in upgrading the existing budget and planning framework. Part of the ongoing effort to upgrade the capacity for budget preparation and implementation is the establishment of a fiscal policy unit, currently designated the Budget Policy Division (BPD) in the Ministry of Finance. Preparations are under way, with Fund technical assistance, to enhance analytical procedures for budget preparation within the BPD.

Budgetary control is being developed also through strengthening budget legislation and the recently introduced borrowing plan which is designed to help coordinate borrowing with other government operations. The Government is in the process of improving its capacity to shape and implement public investment programs while streamlining and rationalizing the use of externally provided funds.

2. Pension reform 1/

In common with other transition economies of Central and Eastern Europe, Lithuania's pension system is under strain owing to the following factors: (a) because of demographic trends since World War II, the system has high and rising dependency ratios (Chart 15); (b) coverage is more extensive than in most other middle income countries at a time when the role of the government in transition economies is shrinking; and (c) reform is made more complicated due to many concurrent structural changes in the economy, including changes in income distribution. Although not high at present, the share of pension costs to GDP is on a rising trend in Lithuania, while average pensions have lagged behind average wages (Chart 16). In addition, in its present form, the system lacks incentives for improving national saving. Based on these considerations, changes are required to ensure the sustainability of the system in the medium term.

From 1990 to 1994, Lithuania made considerable progress toward the development of a coordinated and durable social security system, despite a difficult economic environment. A restructured social security system was enacted in 1994 and the collection of payroll taxes was improved. The pension age, which was below the OECD average as in other Eastern European countries in transition (Table 3), was increased at the beginning of 1995 by four months for women and by two months for men, and is scheduled to

1/ The discussion in this section draws in part on the World Bank paper "Policy Note on Lithuanian Social Security System", July 12, 1995.

Table 3. Lithuania: Average Retirement Age in Public Old-Age Schemes in OECD Countries, Poland, and the Baltics in 1990

Austria (employees and self-employed)	
Males	62.0
Females	59.6
Belgium (employees)	
Males	63.3
Females	60.7
Canada (Canada pension plan)	
Males	63.3
Females	63.1
Finland	
Males	61.9
Females	62.5
Germany (white-collar workers)	
Males	63.0
Females	63.1
France (general scheme)	
Workers	62.0
Japan (employees)	
Males	62.1
Females	61.0
Japan (self-employed)	
Males	64.1
Females	63.7
Luxembourg	
Males	60.6
Females	63.0
Portugal	
Males	65.8
Females	63.6
United Kingdom (category A)	
Males	65.5
Females	61.0
United States (employees)	
Males	63.7
Females	63.5
OECD countries (arithmetic average)	
Males	63.2
Females	62.4
Poland (data for 1993)	
Males	59.0
Females	55.0
Estonia (data for 1993) 1/	
Males	60.0
Females	55.0
Latvia	
Males	60.0
Females	55.0
Lithuania (data for 1994) 1/	
Males	60.0
Females	55.0

Sources: For OECD countries OECD, New Orientations for Social policy (Paris, 1994), p. 90. Retirement age is a weighted average for the basic pension and early old-age pensions. Data for Belgium and Luxembourg are for 1983/84. Data for Poland are for the main social security Fund, FUS. Because of different classification, the OECD average in this table excludes France. Data for Estonia, Latvia and Lithuania provided by the authorities.

1/ Beginning on January 1, 1994 for Estonia and January 1, 1995 for Lithuania, the retirement age started to increase at semi-annual and annual intervals, respectively.

CHART 15
LITHUANIA
PENSION COST INDICATORS

Sources: Lithuanian authorities; and Fund staff estimates.

1/ Women over 55 are included in the non-working population group.

CHART 16
LITHUANIA
AVERAGE PENSION, AND AVERAGE AND MINIMUM WAGE
(In litai per month)

Source: Lithuanian authorities.

increase at the same rate annually until the pension age of 60 years for women and 62 1/2 for men is reached.

Additional legislation passed in 1994, however, and subsequent government decisions, including a generous benefits-setting formula, worsened the prospects for the medium-term financial sustainability of the Social Insurance Fund (SIF). 1/ In the first quarters of 1995 and 1996, the SIF experienced short-term operating deficits which were covered by the depletion of the Fund's financial reserves. The deficits resulted from a fall in tax collection and increased contribution arrears primarily from state-owned enterprises and government agencies. Additional arrears surfaced in the first quarter of 1996 following the closings of some banks in late 1995 and the subsequent freezing of bank accounts belonging to enterprises. Nonetheless, the SIF showed a surplus at the end of 1995 and is expected to be roughly in balance at the end of 1996.

Given Lithuania's demographic structure, the pension system is not sustainable in the medium- and long-term due to the early retirement age, the incentives for early retirement, and an expected shift of the labor force to the private sector. 2/ The main underlying problems of the existing system are the excessively generous formula for setting benefits and the complete reliance on a "pay-as-you-go" system. 3/ This system, if not restructured, will become increasingly difficult to maintain given the rising share of the population that will qualify for pensions. The present pension system provides inadequate savings for retirement, and--as it effectively involves the transfer of income to groups with a high relative propensity to consume--does not contribute to the much needed increase in national saving.

1/ The SIF is an extra-budgetary fund that finances social insurance benefits, principally from social insurance contributions. An independent Social Security Institution (SoDra) administers social insurance and the SIF. The intention is that social security contributions will finance social insurance benefits fully. Pensions account for two thirds of all social security spending, including social assistance which is financed from the state budget and is separate from the SIF.

2/ Under the existing public pension system, most employees, as they start work in small and medium private companies, and the self employed, exit the contributors' pool. The expected move of employees to the informal sector is due in part to the desire to avoid increasing payroll taxes.

3/ A "pay-as-you-go" system takes contributions from today's workers and uses them to pay pensions to today's retirees. It does not add to the stock of savings. Instead, its contribution purchases an "entitlement" to future benefits at some predetermined rate. As the number of retirees rises relative to the number of contributors, owing to the aging of the population, contribution rates have to increase if the same benefit rate is to be maintained; if contribution rates remain unchanged, benefits will have to decrease.

Concrete problems facing the social insurance system include the following: (a) indexation provisions that are built into the 1994 pension formula increase the average rate at which pension spending will grow, and (b) the retired population grows faster than the work force whose contributions finance pension benefits. In order to reduce the cost of the pension system on the economy as a whole, the Government has undertaken to: (a) rationalize pension outlays; (b) accelerate increases in the pension age to six months per year until the retirement age reaches 65 years for both men and women, instead of the lower and differentiated age that is now scheduled; and (c) improve the collection of social insurance contributions. Other measures that could be taken immediately to help reduce costs include the following: (a) increase of the number of years for the calculation of benefits to 35; (b) reallocation of the contribution rate so that half is made by the employer and half by the employee; and (c) the set-up of internal and external control mechanisms to assure transparency and accountability in the books and activities of the SIF. These issues are being addressed in the context of the World Bank's Social Safety Net Project.

The Government has focused its long-term reform efforts on the three functions that public pension systems are intended to perform - saving, redistribution for alleviating old-age poverty, and insurance - and the most efficient ways that these can be achieved. One possibility is a multi-pillar system involving separate administrative and financing mechanisms for redistribution and saving: 1/

(i) A tax-financed, mandatory, publicly managed tier, resembling the existing pension plan, would focus on redistribution of income in old age, thereby providing a social safety net for the old. To accomplish this, the benefit formula for this tier would be flat, means tested, or could provide a minimum pension guarantee;

(ii) A regulated and fully funded, mandatory tier would link benefits actuarially to costs, and would be privately and competitively managed through personal savings plans or occupational pension plans. This tier would focus on saving and would be compulsory in order to force individuals who might be myopic with regard to their future needs to save for themselves. The mandatory nature of this tier would reduce the burden on the tax-financed public tier. Benefits would be linked to contributions to discourage evasion and labor market distortions. If this tier is fully funded, it can reduce intergenerational transfers, which would otherwise be expected given Lithuania's demographics, it can help build national saving, and it can enable higher pensions by financing them partially through investment returns. Private competitive management of these pension funds would also enhance the development of Lithuania's emerging capital market;

1/ See Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth, Oxford University Press, New York, 1994 for a detailed presentation of three-tier pension systems.

(iii) Lastly, there could be a third fully funded, voluntary tier, also managed through personal savings or occupational pension plans, designed to offer additional protection to those who want more income in their old age.

The Government is considering a form of the three-tier option, possibly with a privately funded third tier. There are currently two independent non-governmental teams which are preparing drafts for private pension options to be discussed for implementation.

3. Government borrowing strategy

Access to international capital markets is expected to increase as Lithuania becomes more integrated into the world economy. In this context, the Government is seeking to achieve a more balanced government debt structure by diversifying its borrowing, which would include financing a larger share of the borrowing requirement abroad. On the other hand, the issuance and trade of government paper domestically will contribute to the deepening of the Lithuanian financial market which is in its early stage of development. In this situation, the Government has given consideration to the following factors when diversifying its portfolio:

(a) Fiscal discipline. The Government should retain an appropriate overall fiscal stance notwithstanding the expected increased availability of foreign financing;

(b) Cost of borrowing. The relative costs of borrowing in the domestic and international markets should be weighed. Possible exchange rate changes and roll-over availability in each case need to be considered when comparing costs. Complying with requirements of foreign lenders, and coordinating and matching maturities of loans would become part of the overall borrowing strategy and planning;

(c) Credibility of the exchange rate. As Lithuania establishes a record in borrowing abroad and does so for longer maturities, the credibility of the national currency will be enhanced;

(d) Manageability of foreign debt. The country's foreign debt must not exceed acceptable limits; and

(e) Development of the domestic financial market. As Lithuania is coming out of its banking crisis, financing a larger share of the fiscal deficit externally will alleviate the demands on the domestic financial system and prevent crowding out. In the medium term, however, financing the fiscal deficit domestically and with government securities of varied maturities will encourage the development of domestic financial markets, including the establishment of a secondary market.

V. Trade Reform and Growth

Trade reform is a key element of Lithuania's strategy for achieving high economic growth over the medium term. 1/ Lithuania has maintained a fairly open trading regime despite increasing pressure for protection in agriculture. A trade policy reversal in July 1994, whereby agricultural import tariffs were raised from an average of 25 percent to 44 percent, has been unwound over time; the average import tariff was reduced to 35 percent in October 1994 to 27 1/2 percent in October 1995. These reductions, while imposing significant adjustment costs on some segments of the economy, have resulted in lower food costs to consumers and, in all likelihood, in net efficiency gains. Importantly, the tariff reductions have sent a clear signal to investors that Lithuania intends to rely on market forces to reorient its industrial structure in line with comparative advantage. These unilateral liberalization efforts have been complemented by participation in regional trading arrangements, including with the EU, and by Lithuania's application for WTO membership.

1. Trade policy developments

The average import tariff (unweighted) was 5 1/2 percent in mid-1995 and over 70 percent of items had zero tariff rates. 2/ In May 1996, only three specific import tariffs remained (alcohol, sugar, and tobacco), and there are no quantitative restrictions on imports. However, import tariffs on some agricultural products range up to 45 percent and, although the weighted average tariff rate for eight main agricultural product groups was reduced to 27 1/2 percent on October 1, 1995, it remains high. 3/ There are no quantitative export restrictions or tariffs, except that exportation of four items (feathers and down, raw leather, raw timber, and medical supplies) 4/ is banned except to countries that have signed free trade agreements with Lithuania (such as the EU); such exports face a 50 percent export tariff.

1/ Developments in Lithuania's trade policy regime through mid-1995 were covered in Chapter VII, IMF Staff Country Report No. 95/82, August 1995.

2/ J. Čičinskas, P. Cornelius, and D. Treigienė, "Trade Policies and Lithuania's Reintegration into the Global Economy," Working Paper WP/95/138, International Monetary Fund, Washington, D.C., December 1995.

3/ The eight main agricultural product groups are: sausages, meat, milk and dairy products, butter, sugar, eggs, potatoes, and poultry.

4/ The following products are subject to temporary export prohibitions: feathers and down used for stuffing, raw hides and skins, unprocessed pine and birch timber with thin end diameter not less than 20 cm, unprocessed oak and ash timber, and glands and other organs used for pharmaceutical products and organotherapeutical uses without quotas issued by the Ministry of Health Care. The temporary export prohibition on red clover seeds was eliminated in early May 1996.

Based on a weighted average calculation, 1/ Lithuania's agricultural tariffs remain low compared with its Central European neighbors, but high compared to industrial countries and to some FSU republics. Comparing with other Baltic countries (see Table 4), Estonia does not tax imports, while the average for Latvia is 46 percent. The average tariff rate was 29 percent for the Czech and Slovak Republics and 51 percent for Poland (Table 5). If the comparison is made using the maximum tariff rates within each product group (Table 6), a number of FSU republics (Armenia, Georgia, and Russia) maintain more liberal agricultural tariff regimes than Lithuania.

Table 4. Agricultural Tariffs in Estonia, Latvia, and Lithuania

	HS Codes	Weight	Estonia	Latvia	Lithuania
Sausages	1601	22	--	55	14
Meat	0201-0205, 0209-0210	20	--	55	30
Milk and dairy products	0401-0404	16	--	40	20
Butter	0405	16	--	55	45
Sugar	1701-1702	13	--	20 <u>1/</u>	35 <u>1/</u>
Eggs	0407-0408	7	--	40	30
Potatoes	0701	3	--	40	20
Poultry	0207	3	--	40	25
Weighted average		100	--	46.1	27.5

1/ Specific duties also apply.

1/ This specifies fixed consumption weights (as shown in Table 1) and use of the highest published tariff rate valid for any product sub-category in the calculation, including seasonal tariffs. Specific tariff rates are not included due to the difficulty of computing their ad valorem equivalents.

Table 5. Agricultural Tariffs in the Czech and Slovak Republics and Poland

	HS Codes	Weight	Czech and Slovak Rep.	Poland
Sausages	1601	22	20	35
Meat	0201-0205, 0209-0210	20	30	60
Milk and dairy products	0401-0404	16	30	80
Butter	0405	16	32	40
Sugar	1701-1702	13	50	40
Eggs	0407-0408	7	20	45
Potatoes	0701	3	10	50
Poultry	0207	3	18	60
Weighted average		100	29.1	50.6

Table 6. Agricultural Tariffs in Armenia, Georgia, and Russia

	HS Codes	Weight	Armenia 1/	Georgia	Russia 2/
Sausages	1601	22	--	12	20
Meat	0201-0205, 0209-0210	20	--	12	15
Milk and dairy products	0401-0404	16	--	12	15
Butter	0405	16	--	12	20
Sugar	1701-1702	13	--	12	5
Eggs	0407-0408	7	--	12	10
Potatoes	0701	3	--	12	25
Poultry	0207	3	--	12	15
Weighted average		100	--	12	16

1/ Implementation of a two-tier tariff structure with rates of 0 percent and 10 percent is in process in Armenia.

2/ Tariff rates for Russia are those in effect July 1, 1995.

Comparisons with the EU and the United States show that Lithuania's main industrial country trading partners maintain more liberal agricultural import tariff structures than Lithuania, using Lithuanian consumption weights (Table 7). These averages do not, however, provide an accurate picture of the overall restrictiveness of the EU and U.S. agricultural trade regimes, since they omit many forms of agricultural border protection. In the EU, for instance, the calculation does not take into account the ad valorem equivalent of specific tariff rates, variable import levies (a tax is levied that raises the cost of imports to internal levels), and entry prices (minimum import prices are set above the level of world market prices).

Table 7. Agricultural Tariffs in the European Union and the United States

	HS Codes	Weight	EU	U.S. ^{1/}
Sausages	1601	22	24	8
Meat	0201-0205 0209-0210	20	24	31
Milk and dairy products	0401-0404	16	13	20
Butter	0405	16	13	10
Sugar	1701-1702	13	20	15
Eggs	0407-0408	7	12	0
Potatoes	0701	3	21	0
Poultry	0207	3	10	0
Weighted average		100	19	15

^{1/} Ad valorem tariff rates during 1986.

Lithuania has signed or is in the process of negotiating trade agreements with several countries and regional groupings. The Association Agreement between Lithuania and the EU was signed on June 12, 1995. ^{1/} Lithuania's import tariff rates on imports from the EU were lowered in line with the October 1, 1995 tariff reductions. In December 1995, a new free trade agreement (FTA) was signed with the European Free Trade Association (Iceland, Norway, and Switzerland, and Liechtenstein) that replaced the bilateral free trade treaties between Lithuania and EFTA members, with protocols on basic agricultural products expected to be completed in 1996. Bilateral FTA negotiations are underway with Central European Free Trade Agreement (CEFTA) members (Czech Republic, Hungary, Poland, Slovak Republic,

^{1/} This agreement is discussed in the IMF Staff Country Report No. 95/82, p. 52 and pp. 57-59.

and Slovenia) 1/ with a view to Lithuania's eventual membership in CEFTA. Negotiations with the Czech and Slovak Republics and with Poland have been delayed due to opposition from Lithuania's agricultural interests; the draft FTAs specify that agricultural import tariffs would be eliminated on a bilateral basis within two years (although not all agricultural import tariffs on intra-CEFTA trade would be eliminated under CEFTA provisions). A Baltic Free Trade Agreement has been in effect since April 1, 1994 but this does not cover agricultural products; the Prime Ministers of the Baltic countries have announced the intention to sign a trilateral treaty on free trade in agricultural products in 1996.

Regarding Lithuania's application for membership in the World Trade Organization (WTO), meetings of the working party on Lithuania's accession to the WTO were held in November 1995 and March 1996. Lithuania has responded to questions regarding its trade regime; services were discussed at the March 1996 meeting. The next step is for Lithuania to begin negotiations on tariff bindings, subsidy levels, and services. 2/

2. Economic effects of lower tariffs

Reductions in agricultural import tariffs, from the present 27 1/2 percent average to the 20 percent average planned for March 1997, would be expected to lead to lower import prices, a contraction in domestic agricultural production and employment, an expansion in consumption, and a net increase in national income. This section develops a methodology for quantifying these effects and provides some calculations using this methodology.

Chart 17 illustrates the economic effects of a decrease in the import tariff applied to an agricultural product such as sugar. Domestic demand is given by the curve dd; domestic supply is given by ss. Imports and domestic production are assumed to be perfect substitutes. The supply of imports is perfectly elastic at world price P_w multiplied by one plus the ad valorem tariff rate, t_1 ; this reflects Lithuania's role as a price-taker in world markets. Consumption is equal to OC and domestic production is equal to OP; imports are equal to PC.

A decrease in the agricultural import tariff from t_1 to t_2 would lead to an increase in consumption from C to C^* , a decrease in domestic production from P to P' , and an increase in imports from PC to $P'C^*$. Consumers would benefit by an amount measured by area $P_w(1+t_2) J G P_w(1+t_1)$, which is the change in consumer surplus. Producers would lose an amount measured by $P_w(1+t_2) D E P_w(1+t_1)$, which is the change in producer surplus. The net gains to the Lithuanian economy from this tariff reduction are measured by area DFE plus area HJG, which are the deadweight losses in production and consumption, respectively.

1/ Slovenia became a CEFTA member on January 1, 1996.

2/ Tariff bindings represent a commitment not to raise the tariff rate above the binding.

Chart 17. Effects of Agricultural Tariff Reduction

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Algebraic expressions for these various economic effects are given in Table 8. To apply this methodology empirically, it is necessary to specify the value of imports, elasticities of domestic demand and supply, and imports as a share of domestic consumption and production. It should be stressed that there would be additional, dynamic, benefits from agricultural trade liberalization, due to increased foreign investment and more rapid economic growth, although these effects are not easily quantified.

Table 8. Model Equations

Domestic Demand:

$$\ln C = - \eta_d \ln P_m$$

Domestic Supply:

$$\ln P = \eta_s \ln P_m$$

Change in Import Price:

$$d \ln P_m / d \ln t = (t_2 - t_1) / (1 + t_1)$$

Change in Import Quantity:

$$d \ln M / d \ln P_m = - \eta_d (C/M) - \eta_s (P/M)$$

Change in Producer Surplus:

$$\begin{aligned} & - \text{Area}[P_w(1+t_2) \text{ DE } P_w(1+t_1)] \\ & = - \text{Area}[P_w(1+t_2) \text{ FE } P_w(1+t_1)] + \text{Area}(\text{DFE}) \\ & = - P_w M (P/M) (t_1 - t_2) + (1/2) \{ [P_w(1+t_1)]^{\eta_s} - [P_w(1+t_2)]^{\eta_s} \} P_w (t_1 - t_2) \end{aligned}$$

Change in Consumer Surplus:

$$\begin{aligned} & \text{Area}[P_w(1+t_2) \text{ JG } P_w(1+t_1)] + \text{Area}(\text{HJG}) \\ & = \text{Area}[P_w(1+t_2) \text{ HG } P_w(1+t_1)] + \text{Area}(\text{HJG}) \\ & = P_w M (C/M) (t_1 - t_2) + (1/2) \{ [P_w(1+t_2)]^{-\eta_d} - [P_w(1+t_1)]^{-\eta_d} \} P_w (t_1 - t_2) \end{aligned}$$

Change in Net Economic Welfare:

$$\text{Area}(\text{DFE}) + \text{Area}(\text{HJG})$$

Change in Employment:

$$d \ln E / d \ln P_m = d \ln P / d \ln P_m = \eta_s (t_2 - t_1) / (1 + t_1)$$

Table 9 presents calculations based on the above methodology and assumptions regarding import shares and demand and supply elasticities. This shows a proportional reduction in import tariffs to achieve a weighted average of 20 percent, along with resulting changes in import prices, producer profits, consumer income, net national income, and employment. The calculations illustrate the net national income gains from agricultural import tariff reductions, with gains to consumers outweighing losses to producers; employment losses are also shown, along with the gain to consumers per job lost. These results indicate that the major portion of the benefits from agricultural import tariff liberalization would likely occur in the sugar sector, which accounts for the majority of agricultural imports. The cost of each job in the sugar industry protected by present import tariffs is especially high.

In sum, while there would likely be costs to certain producers and workers (for instance in food processing) from further agricultural import tariff liberalization on the Lithuanian economy, these costs would be more than offset by efficiency gains from improved resource allocation and lower consumer prices; additional gains would likely result from increased foreign investment and more rapid economic growth.

Table 9. Lithuania: Effects of Lowering Agricultural Import Tariffs from a Weighted Average of 27 1/2 Percent to 20 Percent

Product	HS Code	Current Tariff	Reduced Tariff 1/	Change in Import Price (percent)	Change in Producer Profits due to Reduced Tariffs (thou. Lit)	Change in Consumer Income due to Reduced Tariffs (thou. Lit)	Net Change in National Income due to Reduced Tariffs (thou. Lit)	Employment (no. of workers)	Change in Employment (no. of workers)	Consumer Gain per Job Lost (thou. Lit/ worker)
Sausages and similar products of meat	1601	14	10	-25.5	-2	390	141			
Meat	0201-0205, 0209-0210	30	22	-26.4	-74	13,197	4,891	7,785	-2,055	6
Meat of bovine, fresh, chilled	0201									
Meat of bovine, frozen	0202									
Meat of swine, fresh, chilled or frozen	0203									
Meat of sheep or goats, fresh, chilled or frozen	0204									
Pig fat free of lean meat and poultry fat	0209									
Meat and edible meat offal	0210									
Milk and dairy	0401-0404	20	15	-26.0	-31	5,486	2,010	12,396	-3,220	2
Milk and cream, not concentr. or sweetened	0401									
Milk and cream, concentr. or sweetened	0402									
Yogurt and buttermilk	0403									
Whey	0404									
Butter	0405	45	33	-26.7	-4	774	289			
Sugar	1701-1702	35	25	-26.5	-513	90,947	33,816	1,875	-497	182
Sugar	1701									
Other sugar	1702									
Eggs	0407-0408	30	22	-26.4	-12	2,122	786			
Birds' eggs	0407									
Bird's eggs not in shell, dried whole eggs	0408									
Potatoes	0701	20	15	-26.0	-6	1,048	384			
Meat of poultry	0207	20	15	-26.0	-37	6,502	2,382			
Total		27.3	19.9		-679	120,466	44,698			

Sources: Lithuanian Department of Statistics; and Fund staff estimates.

1/ Current tariffs have been reduced proportionately to achieve a weighted average of 20 percent.

Table 1. Lithuania: Gross Domestic Product by Sector at Current Prices

	1992	1993	1994	1995 <u>1/</u>
Agriculture	11.6	11.0	7.3	8.7
Electricity and gas	3.9	5.6	2.7	2.9
Industry	35.5	24.8	23.1	24.3
Construction	9.3	7.8	8.7	7.4
Trade, commerce, and communication	6.5	18.2	25.6	27.2
Transportation	7.1	9.3	7.7	5.9
Financial services	6.5	7.3	4.5	3.3
Government services	6.3	7.7	8.9	9.6
Other services	11.9	5.4	6.1	6.6
Other <u>2/</u>	1.5	3.1	5.5	4.3
Total	100.0	100.0	100.0	100.0

Source: Data provided by the Lithuanian authorities.

1/ Based on first three quarters.

2/ Includes imputed rent.

- 40 -

APPENDIX I

Table 2. Lithuania: Industrial Production Sold by Sectors
(At current prices; in percent of total)

	1992	1993	1994
Total	100.0	100.0	100.0
Foodstuff & drinks	35.4	28.7	32.2
Tobacco	0.8	0.5	0.8
Textiles	12.0	7.7	8.1
Wood	1.4	1.2	1.5
Paper	1.9	1.1	1.5
Oil refining	13.1	30.1	24.2
Chemical refining	5.2	3.8	5.8
Nonmetal minerals	5.6	3.9	4.5
Metal articles	1.5	0.9	0.9
Machinery & equipment	5.8	5.5	5.1
Other	17.3	16.6	15.5

Source: Data provided by the Lithuanian authorities.

Table 3. Lithuania: Real Sector Indicators

	1989	1990	1991	1992	1993	1994	1995
<u>(In percent of GDP)</u>							
Domestic demand	108.1	108.5	90.6	97.6	110.2	105.2	103.5
Foreign balance	-8.1	-8.5	9.4	2.4	-10.2	-5.2	-3.5
GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<u>(Percentage changes)</u>							
GDP/NMP <u>2/</u>	1.5	-5.0	-13.4	-37.7	-24.2	1.0	3.1
<u>(In thousands)</u>							
Total employment	1,903	1,853	1,898	1,855	1,778	1,675	1,644
Of which: in state sector	1,523	1,440	1,334	1,089	815	662	517
<u>(In percent)</u>							
Unemployment rate <u>2/</u>	--	--	0.3	1.3	4.4	3.8	6.1
<u>(Percentage changes)</u>							
Consumer/retail prices <u>4/</u>	2.1	8.4	224.7	1,020.5	410.4	72.1	39.5
Real wages <u>5/</u>	...	7.1	-19.9	-17.2	-45.9	20.6	1.2

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

1/ Preliminary data.

2/ NMP for 1990, GDP thereafter.

3/ Calculated on the basis of registered unemployed.

4/ Retail price index for 1990, consumer price index thereafter.

5/ Average wages deflated by retail/consumer price index.

Table 4. Lithuania: Labor Force and Employment

	1990	1991	1992	1993	1994	1995
Population (end of year)	3,737	3,747	3,756	3,725	3,718	3,715
Working age ^{1/}	2,115	2,126	2,113	2,104	2,100	2,111
Labor force	1,853	1,903	1,879	1,859	1,741	1,753
Employment	1,853	1,898	1,855	1,778	1,675	1,644
Working age	1,696	1,771	1,731	...	...	...
Nonworking age	157	127	124	...	...	...
Unemployed ^{2/}	--	5	24	81	66	109
Male	--	...	...	45	31	49
Female	--	...	...	36	34	60
Labor force participation rate ^{3/}	87.6	89.5	88.9	88.4	82.9	83.0
Unemployment rate ^{2/}	--	0.3	1.3	4.4	3.8	6.2

Source: Data provided by the Lithuanian authorities.

^{1/} Ages 16–55 for women and 16–60 for men.

^{2/} Derived as the difference between labor force and employment.

^{3/} Labor force in percent of working age population.

Table 5. Lithuania: Registered Unemployment at Labor Exchanges 1/ 2/
(In thousands)

Year	Month	Rate in percent	Total	Male	Female
1991	March	...	1.7	0.6	1.1
	April	...	1.7	0.6	1.1
	May	...	2.2	0.8	1.5
	June	...	2.8	0.9	1.9
	July	...	3.8	1.6	2.2
	August	...	4.0	1.8	2.2
	September	...	4.2	1.3	3.0
	October	...	4.3	1.5	2.9
	November	...	4.6	1.6	3.0
	December	...	4.7	1.6	3.1
1992	January	...	4.2	1.4	2.8
	February	...	4.6	1.6	3.0
	March	...	5.2	1.9	3.4
	April	...	6.5	2.5	4.1
	May	...	7.3	2.7	4.6
	June	...	7.3	2.7	4.6
	July	...	7.7	2.8	4.8
	August	...	8.9	3.3	5.6
	September	...	11.2	3.9	7.3
	October	...	12.7	4.3	8.4
	November	...	16.7	6.2	10.5
	December	...	20.7	8.2	12.4
1993	January	1.3	24.8	10.4	14.4
	February	1.5	27.3	11.3	15.9
	March	1.6	29.2	12.0	17.2
	April	1.6	30.1	12.4	17.7
	May	1.7	31.5	13.5	18.1
	June	1.7	32.2	14.4	17.8
	July	1.8	32.9	14.8	18.1
	August	1.7	32.4	14.2	18.1
	September	1.7	32.1	14.1	18.0
	October	1.6	31.5	13.6	17.8
	November	1.6	30.8	13.2	17.6
	December	1.6	30.5	12.5	17.9
1994	January	1.4	30.5	12.5	17.9
	February	1.4	29.8	12.0	17.8
	March	1.4	29.3	11.4	17.9
	April	1.4	28.5	10.9	17.6
	May	1.3	27.4	10.3	17.1
	June	1.3	26.7	9.7	17.0
	July	1.2	26.0	9.5	16.4
	August	1.2	26.2	9.6	16.5
	September	1.3	26.9	10.0	16.9
	October	1.4	28.6	10.6	18.0
	November	1.4	30.2	11.2	19.0
	December	1.5	31.7	11.9	19.8
1995	January	5.2	90.1	43.0	47.0
	February	5.4	100.8	48.2	52.6
	March	5.7	107.7	51.0	56.7
	April	5.8	107.9	50.2	57.7
	May	5.8	107.4	49.2	58.2
	June	6.0	104.5	47.1	57.4
	July	6.0	103.7	46.1	57.6
	August	6.1	106.9	46.8	60.1
	September	6.3	110.2	48.0	62.2
	October	6.7	116.8	50.6	66.2
	November	7.1	124.4	54.9	69.5
	December	7.3	127.7	57.4	70.3
1996	January	7.9	137.4	63.2	74.2
	February	8.2	142.3	66.3	76.0
	March	8.3	144.2	67.8	76.4
	April	8.0	139.6	65.3	74.3

Source: Data provided by the Lithuanian authorities.

1/ Non-employed seeking work are referred to as unemployed as of January 1995.

2/ Beginning of month data through December 1994, end of month data as of January 1995.

Table 6. Lithuania: Employment Distribution

	1990	1991	1992	1993	1994	1995
<u>(In thousands)</u>						
Total	1,853	1,898	1,856	1,778	1,675	1,644
State sector	1,440	1,334	1,089	815	645	517
Collective farms	343	270	--	--	--	--
Self-employed	9	88	92	320	...	...
Private employment	60	206	675	643	1,030	1,127
<u>(In percent of total)</u>						
State sector	77.7	70.3	58.7	45.8	38.5	31.4
Collective farms	18.5	14.2	--	--	--	--
Self-employed	0.5	4.6	4.9	18.0	...	...
Private employment	3.2	10.9	36.4	36.2	61.5	68.6
Memorandum item:						
Change in total employment (percent)	-2.7	2.4	-2.2	-4.2	-5.8	-1.9

Source: Data provided by the Lithuanian authorities.

Table 7. Lithuania: Wages and Prices

		Consumer Prices 1/		Average Wage		Real Wages Index
		Index	Percentage Change	Index	Percentage Change	
1991	January	100	...	100	...	90 2/
	February	108	8.4	100	...	90 2/
	March	127	17.1	100	...	90 2/
	April	161	27.1	142	...	88
	May	177	9.6	163	14.5	92
	June	188	6.6	184	13.0	98
	July	199	5.5	208	12.9	104
	August	207	4.2	212	2.4	103
	September	214	3.5	231	8.5	108
	October	227	6.0	321	39.1	141
	November	291	27.8	418	30.4	144
	December	445	53.0	675	61.3	152
1992	January	685	54.0	710	5.3	104
	February	975	42.4	872	22.8	89
	March	1,152	18.2	1,010	15.8	88
	April	1,271	10.3	1,284	27.1	101
	May	1,357	6.8	1,552	20.9	114
	June	1,524	12.3	1,799	15.9	118
	July	1,939	27.2	1,927	7.1	99
	August	2,214	14.2	2,065	7.2	93
	September	2,865	29.4	2,456	18.9	86
	October	3,407	18.9	2,566	4.5	75
	November	4,395	29.0	2,587	0.8	59
	December	5,612	27.7	2,716	5.0	48
1993	January	6,145	9.5	2,939	8.2	48
	February	6,772	10.2	3,741	27.3	55
	March	8,221	21.4	4,209	12.5	51
	April	10,276	25.0	4,663	10.8	45
	May	11,581	12.7	5,004	7.3	43
	June	12,311	6.3	5,999	11.9	45
	July	12,668	2.9	5,974	6.7	47
	August	12,782	0.9	6,123	2.5	48
	September	13,319	4.2	6,479	5.8	49
	October	14,291	7.3	7,055	8.9	49
	November	15,263	6.8	7,810	10.7	51
	December	16,209	6.2	9,083	16.3	56
1994	January	16,987	4.8	9,757	7.4	57
	February	17,480	2.9	9,952	2.0	57
	March	18,057	3.3	10,828	8.8	60
	April	18,346	1.6	10,763	-0.6	59
	May	19,502	6.3	11,441	6.3	59
	June	19,911	2.1	11,979	4.7	60
	July	20,329	2.1	12,123	1.2	60
	August	20,776	2.2	12,135	0.1	58
	September	21,254	2.3	12,171	0.3	57
	October	21,849	2.8	12,841	5.5	59
	November	22,636	3.6	13,110	2.1	58
	December	23,496	3.8	15,496	18.2	66
1995	January	24,835	5.7	13,761	-11.2	55
	February	25,804	3.9	14,476	5.2	56
	March	26,165	1.4	14,889	2.9	57
	April	26,532	1.4	15,863	6.5	60
	May	27,115	2.2	16,469	3.8	61
	June	27,386	1.0	16,901	2.6	62
	July	28,126	2.7	17,423	3.1	62
	August	28,238	0.4	17,641	1.2	62
	September	28,803	2.0	17,297	-1.9	60
	October	29,725	3.2	18,741	8.3	63
	November	31,003	4.3	18,815	0.4	61
	December	31,840	2.7	21,995	16.9	69
1996	January	32,859	3.2	21,989	--	67
	February	33,648	2.4	20,841	-5.2	62
	March	34,421	2.3	21,753	4.4	63
	April	34,869	1.3	...	...	...

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

1/ Until May 1992, based on a retail price index for goods and services. Subsequently based on the new consumer price index.

2/ Average for the first quarter of 1991.

3/ Average wage divided by average price for the quarter.

Table 8. Lithuania: Average Monthly Wages

	1990	1991	1992	1993	1994	1995
	<u>(In litai/litai equivalent)</u>					
Whole economy	2.98	6.83	61.31	166.12	325.40	515.83
State sector	2.83	7.37	56.15	189.65	371.00	574.33
Agriculture	2.75	5.71	47.81	122.01	292.00	419.60
Industry	3.03	8.60	63.02	208.55	333.00	566.46
Transport	3.04	7.04	59.81	245.80	451.00	734.42
Construction	3.93	8.45	67.96	194.74	422.00	561.25
Health care	1.85	6.45	45.25	134.55	267.00	377.28
Education	1.85	6.25	44.68	129.46	272.00	393.16
Banking and insurance	4.00	10.54	94.62	501.56	716.81	1064.23
Collective farms	3.03	5.37	24.02	81.41	155.00	...
Cooperative and private sector	3.72	5.19	42.71	142.27	284.90	515.51
Minimum wage (end of year)	0.70	5.10	17.00	48.00	65.00	180.00

Source: Data provided by the Lithuanian authorities.

Table 9. Lithuania: Supply and Use of Energy
(In thousands of tons of oil equivalent)

	1989	1990	1991	1992	1993	1994	1995 <u>1/</u>
Total sources and uses	18.57	17.26	18.00	11.37	9.36	8.46	9.03
Sources							
Liquid fuel	9.02	7.28	8.03	4.32	4.11	3.90	3.12
Gas	4.14	4.67	4.84	2.76	1.50	1.72	2.03
Coal and coke	1.02	0.79	0.65	0.40	0.41	0.28	0.24
Domestic fuel	0.32	0.36	0.35	0.35	0.35	0.42	0.53
Hydro energy	0.03	0.04	0.03	0.03	0.03	0.04	0.05
Nuclear energy	4.04	4.12	4.10	3.51	2.96	2.10	3.08
Uses							
Intermediate use	13.10	12.34	12.78	7.75	6.26	5.48	6.46
Electricity	6.48	6.33	6.53	4.15	3.25	2.45	3.38
Heating	4.02	3.81	3.95	2.78	2.19	2.28	2.24
Oil refinery and losses	0.94	0.74	0.87	0.33	0.49	0.38	0.30
Other uses	1.66	1.46	1.43	0.49	0.33	0.37	0.54
Final use of fuel	5.47	4.92	5.22	3.62	3.10	2.98	2.57
Industry and construction	1.21	1.09	1.16	0.83	0.61	0.50	0.42
Transportation	1.87	1.68	1.78	1.34	1.10	1.09	1.00
Agriculture	0.49	0.45	0.46	0.26	0.25	0.21	0.14
Households	1.19	1.09	1.15	0.73	0.80	0.83	0.72
Other	0.71	0.61	0.67	0.46	0.35	0.36	0.29
Memorandum item:							
Oil processing (in million tons)	12.8	9.5	11.7	4.1	5.2	3.8	3.3

Source: Data provided by the Lithuanian authorities.

1/ Preliminary estimates.

Table 10. Lithuania: Electricity Production and Consumption
(In millions of Kwh)

	1988	1989	1990	1991	1992	1993	1994	1995 <u>1/</u>
Gross production	26,000	29,158	28,405	29,363	18,707	14,122	10,021	13,900
Thermal	12,802	12,133	10,958	12,025	3,599	1,283	1,597	1,325
Hydro <u>2/</u>	389	379	414	338	470	579	718	753
Nuclear	...	16,646	17,033	17,000	14,638	12,260	7,706	11,822
Used at power plants <u>2/</u>	1,949	2,124	2,109	2,205	1,985	1,837	1,945	2,050
Net production	24,051	27,034	26,296	27,158	16,722	12,377	8,199	11,999
Thermal	11,957	11,286	10,183	11,208	3,156	1,042	1,122	990
Hydro	387	377	412	336	232	298	450	372
Nuclear	11,707	15,371	15,701	15,614	13,334	11,037	6,627	10,637
Imports	4,144	4,245	4,539	3,725	5,338	5,735	7,114	5,270
Exports	13,363	16,378	16,513	16,475	10,641	8,467	6,015	7,948
Losses	1,677	1,636	1,552	1,714	1,686	1,910	1,978	2,005
Domestic consumption	13,155	13,265	12,770	12,694	9,733	7,735	7,197	7,158
Energy sector	636	757	757	804	506	756	737	711
Final consumption	12,519	12,508	12,013	11,890	9,227	6,979	6,460	6,447
Industry	5,860	5,757	5,202	4,818	3,489	2,963	2,798	2,938
Construction	288	268	257	207	151	115	0	0
Transportation	221	210	212	231	207	150	145	150
Agriculture	2,650	2,727	2,697	2,592	1,796	870	695	523
Households	1,572	1,671	1,762	1,836	1,797	1,437	1,541	1,485
Others	1,928	1,875	1,883	2,206	1,787	1,444	1,281	1,351

Source: Data provided by the Lithuanian authorities.

1/ Preliminary estimates.

2/ Including hydro pump storage.

Table 11. Lithuania: Domestic Consumers' Energy Arrears
(In millions of litai)

	1994				1995				1996			
	Mar	June	Sep	Dec	Mar	June	Sep	Dec	Jan	Feb	Mar	Apr
Lithuanian Power Company (LPC) claims for electricity												
Total	55.5	74.9	115.3	140.5	176.5	184.0	100.2	93.3	88.9	106.5	118.4	126.2
Of which:												
Industry	29.6	43.3	71.5	86.0	100.2	105.2	34.5	32.6	29.2	34.1	38.4	42.9
Agriculture	14.5	18.5	28.9	24.4	27.6	26.4	19.2	13.1	13.7	17.3	16.7	16.5
Services incl.budgetary	11.4	13.1	14.9	30.1	48.7	52.4	30.4	33.6	32.6	41.8	50.0	53.5
Lithuanian Power Company (LPC) claims for heating												
Total	132.7	153.5	165.0	210.6	234.7	242.1	161.1	153.3	181.5	213.2	205.4	224.1
Of which:												
Industry	62.6	61.4	72.0	58.1	73.3	73.6	38.1	14.7	18.4	21.6	21.2	23.4
Agriculture	3.9	2.5	2.3	2.5	5.5							
Services incl.budgetary	26.7	46.9	38.7	65.8	84.4	93.7	72.8	67.0	75.0	88.4	92.2	104.1
Households	39.5	42.7	52.0	84.2	71.5	60.9	42.8	61.2	77.4	88.2	76.0	79.6
Lithuanian Gas claims for natural gas supplies 1/												
Total	47.9	40.0	46.4	58.8	56.2	54.5	37.1	47.8	52.6	58.2	54.6	54.0
Of which:												
Industry	19.7	16.1	18.5	21.2	24.8	23.3	17.9	12.5	13.0	13.1	12.1	10.9
Agriculture	8.3	9.0	10.4	12.8	4.7	3.6	2.7	13.4	15.1	15.2	14.6	14.5
Services incl.budgetary	7.0	6.6	4.8	6.1	9.4	13.6	5.2	6.0	11.5	13.2	11.6	11.6
Households	12.9	8.3	12.7	18.7	17.3	13.9	11.3	16.0	13.0	16.7	16.4	17.1
Total LPC and Lithuanian Gas claims for energy 1/												
Total	236.1	268.4	326.7	409.9	467.4	480.6	298.4	294.4	323.0	377.9	378.4	404.3
Of which:												
Industry	111.9	120.8	162.0	165.3	198.3	202.1	90.5	59.8	60.6	68.8	71.7	77.2
Agriculture	26.7	30.0	41.6	39.7	37.8	30.0	21.9	26.4	28.8	32.5	31.2	31.0
Services incl.budgetary	45.1	66.6	58.4	102.0	142.5	159.7	108.4	106.6	119.0	143.4	153.8	169.2
Households	52.4	51.0	64.7	102.9	88.8	74.8	60.2	82.7	95.7	111.5	97.9	102.8

Sources: Lithuanian Power Company (LPC); and Lithuanian Gas.

1/ Excluding Lithuania Gas claims for natural gas supplies to the LPC estimated at Lit. 200 million at the end of March 1995.

Table 12. Lithuania: Summary of General Government Fiscal Operations 1/

	1990	1991	1992	1993	1994	1995
<i>(In millions of Litai)</i>						
Total revenue	56	158	1,039	3,473	5,472	7,760
Tax revenue	46	152	1,006	3,222	5,315	7,625
Income and profits	20	46	357	1,257	1,742	2,244
Payroll tax	6	39	265	774	1,481	2,035
VAT & excises	19	58	360	972	1,578	2,786
Other taxes	1	9	25	219	514	560
Non-tax revenue	10	6	33	251	157	136
Expenditure and net lending	52	112	2,580	4,070	6,508	8,689
Expenditure	52	104	2,583	3,402	5,920	8,228
Current expenditure	46	86	2,499	3,011	5,252	7,303
Wages and Salaries	...	...	...	683	1,468	2,267
Transfers	...	...	...	1,109	1,829	2,392
Subsidies	...	...	...	163	293	274
Other	...	...	...	1,052	1,641	2,270
Interest	...	...	...	3	23	100
Investment	6	18	84	392	668	925
Other Balances 2/	...	...	...	...	61	5
Discrepancy 3/	--	--	--	-110	-53	83
Financial balance	15	60	-1512	291	-334	-557
Net Leading	--	8	-3	668	588	461
Fiscal balance	15	52	-1509	-377	-922	-1,018
Borrowing requirement	-15	-52	1509	377	922	1,018
Foreign financing	--	--	24	841	482	776
Domestic financing	-4	-16	-83	-464	440	242
Bank financing 4/	-4	-16	-111	-563	329	-75
Privatization receipts	...	...	28	99	67	38
Treasury Bills	--	--	--	--	44	279
<i>(In percent of GDP)</i>						
Total revenue	43.7	41.5	32.1	28.4	24.6	25.0
Tax revenue	35.6	39.9	31.1	26.4	23.9	24.5
Income and profits	15.5	12.0	11.0	10.3	7.8	7.2
Payroll tax	4.6	10.2	8.2	6.3	6.7	6.5
VAT & excises	14.7	15.2	11.1	8.0	7.1	9.0
Other taxes	0.8	2.4	0.8	1.8	2.3	1.8
Non-tax revenue	8.1	1.6	1.0	2.1	0.7	0.4
Expenditure and net leading	40.3	29.3	79.8	33.3	29.3	27.9
Expenditure	40.3	27.2	79.8	27.8	26.7	26.5
Current expenditure	35.7	22.5	77.2	24.6	23.6	23.5
Wages and Salaries	--	--	--	5.6	6.6	7.3
Transfers	--	--	--	9.1	8.2	7.7
Subsidies	--	--	--	1.3	1.3	0.9
Other	--	--	--	8.6	7.4	7.3
Interest	--	--	--	0.0	0.1	0.3
Investment	4.7	4.7	2.6	3.2	3.0	3.0
Other Balances 2/	...	...	...	--	0.3	--
Discrepancy 3/	--	--	--	-0.9	-0.2	0.3
Financial balance	11.5	15.8	-46.7	2.4	-1.5	-1.8
Net Leading	--	2.1	-0.1	5.5	2.6	1.5
Fiscal balance	11.5	13.7	-46.6	-3.1	-4.2	-3.3
Borrowing requirement	-11.5	-13.7	46.6	3.1	4.2	3.3
Foreign financing	--	--	0.7	6.9	2.2	2.5
Domestic financing	-2.7	-4.3	-2.6	-3.8	2.0	0.8
Bank financing 4/	-2.7	-4.3	-3.4	-4.6	1.5	-0.2
Privatization receipts	--	--	0.9	0.8	0.3	0.1
Treasury Bills	--	--	--	--	0.2	0.9

Sources: Data provided by the Lithuanian authorities; and Fund staff projections.

1/ Includes the State Budget, Municipal Budgets, Privatization Funds, and the Social Security Fund.

2/ Balances of budgetary organizations not recorded in the above the line numbers.

3/ Discrepancy between above and below the line estimates of the financial balance.

4/ The definition of net credit to Government in the monetary accounts differs from the definition in the fiscal accounts.

Table 13. Lithuania: General Government Revenue

	1990	1991	1992	1993	1994	1995
(In millions of Litai)						
Total revenue	56	158	1,039	3,473	5,472	7,760
Tax revenue	46	152	1,006	3,222	5,315	7,625
Income & profits taxes	20	46	357	1,257	1,742	2,244
Taxes on companies	14	26	189	642	553	554
Taxes on individuals	6	20	168	615	1,188	1,690
Payroll or social security	6	39	265	774	1,481	2,035
Taxes on goods & services	19	58	360	972	1,578	2,786
Excise Taxes	4	13	111	212	281	614
Road Tax	--	--	--	--	148	197
VAT/GET 1/	15	45	240	760	1,149	1,975
Special Funds	--	5	9	--	--	--
Property taxes	--	4	3	28	39	157
Foreign trade	1	--	2	100	283	187
Other taxes	--	5	20	92	192	216
State fees and charges	--	1	9	41	119	156
Taxes on fixed assets	--	4	10	38	45	26
Taxes on pollution	--	--	--	3	6	9
Natural resource tax	--	--	1	10	18	19
Taxes on market places	--	--	--	--	4	5
Nontax revenue	10	6	33	251	157	136
Penalty	--	--	4	36	27	52
Other	10	6	28	215	130	84
(In percent of GDP)						
Total revenue	43.7	41.4	32.1	28.5	24.5	25.0
Tax revenue	35.6	39.9	31.1	26.4	23.8	24.5
Income and profits taxes	15.5	12.0	11.0	10.3	7.8	7.2
Taxes on companies	10.9	6.8	5.8	5.3	2.5	1.8
Taxes on individuals	4.7	5.2	5.2	5.0	5.3	5.4
Payroll or social security	4.6	10.2	8.2	6.3	6.6	6.5
Taxes on goods & services	14.7	15.2	11.1	8.0	7.1	9.0
Excise taxes	3.4	3.4	3.4	1.7	1.3	2.0
Road tax	--	--	--	--	0.7	0.6
VAT/GET	11.3	9.7	7.4	6.2	5.1	6.4
Special Funds	--	1.3	0.3	--	--	--
Property taxes	--	1.1	0.1	0.2	0.2	0.5
Foreign trade	0.8	0.0	0.1	0.8	1.3	0.6
Other taxes	--	1.3	0.6	0.8	0.9	0.7
State fees and charges	--	0.3	0.3	0.3	0.5	0.5
Taxes on fixed assets	--	1.0	0.3	0.3	0.2	0.1
Taxes on pollution	--	--	--	--	--	0.0
Natural resources tax	--	--	--	0.1	0.1	0.1
Nontax Revenue	8.1	1.6	1.0	2.1	0.7	0.4
Penalty	--	--	0.1	0.3	0.1	0.2
Other	8.1	1.6	0.9	1.8	0.6	0.3

Sources: Data provided by Lithuanian Authorities and Fund staff estimates.

1/ Before May 1994 GET.

Table 14. Lithuania: General Government Expenditure

	1990	1991	1992	1993	1994	1995
(In millions of Litai)						
Expenditure	63	140	1,014	3,402	5,920	8,228
Current expenditure	57	122	930	3,011	5,252	7,303
Wages and Salaries	...	...	...	683	1,468	2,267
State Budget	...	...	...	323	719	1,188
Local Budgets	...	...	...	350	723	1,032
Other	...	...	...	10	26	47
Goods and Services	...	...	...	1,052	1,641	2,270
Transfers to Households	...	...	...	1,109	1,829	2,392
Pensions	9	23	187	542	1,072	1,492
Sickness Benefits	1	4	18	45	75	75
Unemployment Fund	--	2	5	38	32	53
Subsidies to Enterprises	18	21	68	163	293	274
Agriculture	...	...	...	...	75	...
Energy	...	...	...	...	86	...
Interest Payments	--	--	--	3	23	100
Capital Expenditures	6	18	84	392	668	925
Memorandum Item:						
Military Expenditures	...	...	...	86	81	...
(In percent of GDP)						
Expenditure	49.1	36.6	31.4	27.9	26.5	26.5
Current expenditure	44.4	31.9	28.8	24.7	23.5	23.5
Wages and Salaries	...	...	...	5.6	6.6	7.3
State Budget	...	...	...	2.7	3.3	3.8
Local Budgets	...	...	...	2.9	3.3	3.3
Other	...	...	...	0.1	0.1	0.2
Goods and Services	...	...	...	8.6	7.3	7.3
Transfers to Households	...	...	...	9.1	8.2	7.7
Pensions	7.0	6.0	5.8	4.4	4.8	4.8
Sickness Benefits	0.1	0.1	0.1	0.1	0.1	0.2
Unemployment Fund	0.0	0.5	0.1	0.3	0.1	0.2
Subsidies to Enterprises	14.0	5.5	2.1	1.3	1.3	0.9
Agriculture	...	...	...	...	0.3	...
Energy	...	...	...	...	0.3	...
Interest Payments	--	--	--	--	0.1	0.3
Capital Expenditures	4.7	4.7	2.6	3.2	3.0	3.0
Memorandum Item:						
Military Expenditures	...	...	...	0.7	0.4	...

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

Table 15. Lithuania: Monetary Authorities
(In millions of litai, end of period)

	<u>1994</u>		<u>1995</u>			<u>1996</u>
	<u>Dec.</u>	<u>Mar.</u>	<u>June</u>	<u>Sep.</u>	<u>Dec.</u>	<u>Mar.</u>
Foreign Assets	2,618	2,557	2,435	2,955	3,285	2,778
Gold	248	248	248	248	248	248
Convertible foreign exchange	2,041	1,983	2,131	2,628	2,956	2,468
Nonconvertible foreign exchange	269	268	--	--	1	--
Other foreign assets	--	--	--	--	8	8
Holdings of SDRs	60	58	56	79	73	54
Claims on Central Government	--	--	--	--	19	2
Claims on Private Sector	6	6	7	12	12	12
Claims on Deposit Money Banks	157	147	153	168	168	188
Loans and overdrafts	155	146	152	167	167	186
Central bank deposits at banks	2	1	1	1	2	2
Other Assets	93	55	143	125	146	197
Reserve Money	1,807	1,729	1,867	2,171	2,439	1,942
Currency outside BoL	1,411	1,300	1,525	1,728	1,984	1,730
Deposit money banks' deposits	391	423	335	434	447	205
Reserves in Litai	259	254	182	269	276	201
Required reserves in foreign currency	132	169	153	165	172	4
Private sector deposits	5	6	7	9	8	7
Liabilities to Deposit Money Banks	1	1	1	1	1	--
Nonmonetary Financial Institutions	--	--	3	40	44	49
Foreign Liabilities	527	556	460	533	557	534
Nonresident deposits	2	5	5	7	3	4
Borrowing from banks abroad	4					
Bilateral payments agreements	101	101	1	--	--	--
Use of Fund credit	420	451	454	526	554	531
Central Government Deposits	45	26	23	102	111	112
Counterpart Funds	15	17	16	16	38	36
Government Lending Funds	1	--	--	--	1	--
Capital Accounts	414	417	323	346	413	434
Other Liabilities	66	20	44	51	27	68

Source: Bank of Lithuania.

Table 16. Lithuania: Monetary Survey
(In millions of litai, end of period)

	1993	1994	1995				1996
	Dec.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Net Foreign Assets	1,586	2,148	1,981	1,960	2,606	2,829	2,337
Foreign assets (MA)	1,905	2,618	2,557	2,435	2,955	3,285	2,778
Less: Foreign liabilities (MA)	585	527	556	460	533	557	534
Foreign assets (DMB)	303	401	438	427	641	493	519
Less: Foreign liabilities (DMB)	37	344	458	443	457	392	426
Net Domestic Assets	1,087	2,224	2,512	2,903	2,833	2,892	2,634
Domestic Credit	1,629	2,926	3,178	3,373	3,279	3,340	3,083
Net claims on central government	-390	-500	-638	-675	-856	-752	-796
Claims on central government (MA)	--	--	--	--	--	19	2
Less: Central government deposits (MA)	93	45	26	23	102	111	112
Claims on central government (DMB)	--	241	108	122	315	509	493
Less: Central government deposits (DMB)	123	304	328	334	575	624	668
Less: government lending funds (MA)	--	1	--	--	--	1	0
Less: government lending funds (DMB)	174	338	358	404	460	480	467
Less: State social insurance fund (DMB)	--	53	34	36	34	65	45
Claims on state and local governments (DME)	--	2	2	4	4	8	9
Claims on nonfinancial public enterprises	409	399	346	291	195	238	155
Claims on private sector	1,394	3,016	3,446	3,731	3,914	3,828	3,705
Claims on private sector (MA)	1	6	6	7	12	12	12
Claims on private sector (DMB)	1,393	3,010	3,439	3,724	3,902	3,816	3,694
Claims on nonmonetary financial institutions	5	9	22	22	21	19	10
Leasings (DMB)	--	--	--	--	--	--	--
Overdrafts	211	--	--	--	--	--	--
Counterpart Funds	16	43	49	67	63	90	88
Other Items, Net	526	659	616	403	383	358	361
Broad Money	2,673	4,373	4,493	4,863	5,439	5,721	4,971
Money	1,746	2,474	2,434	2,658	3,122	3,510	3,049
Currency outside banks	791	1,334	1,251	1,468	1,668	1,906	1,665
Demand deposits (MA)	0	5	6	8	9	13	17
Demand deposits (DMB)	955	1,135	1,177	1,182	1,445	1,591	1,367
Quasi-money	927	1,899	2,059	2,205	2,317	2,211	1,921
Time deposits	245	719	653	658	666	702	565
Foreign currency deposits	681	1,180	1,406	1,547	1,650	1,509	1,357

Source: Bank of Lithuania.

Table 17. Lithuania: Interest Rates at Commercial Banks
(Percent per annum) 1/

	1994				1995				1996
	Mar.	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
(Transactions in domestic currency)									
<u>On loans</u>									
From 3 to 6 months	79.2	65.0	52.7	28.9	34.2	30.1	27.1	21.8	25.1
Over 1 year	26.8	30.7	30.9	22.1	27.2	22.2	22.2	10.4	16.8
Average of all loans	76.4	69.5	46.3	29.8	29.1	27.4	26.5	23.9	24.2
<u>On deposits</u>									
Demand deposits	17.3	12.1	11.5	7.6	7.5	7.4	7.2	7.4	5.9
From 1 to 3 months	60.6	55.0	35.8	19.4	20.4	21.2	21.9	17.6	15.4
From 6 to 12 months	62.1	72.0	41.4	25.0	18.8	20.2	22.5	17.0	11.4
Average of all deposits	37.7	28.9	21.2	8.9	8.9	8.6	8.7	8.0	6.2
(Transactions in convertible currency)									
<u>On loans</u>									
From 3 to 6 months	62.1	54.1	44.1	37.8	29.4	26.0	23.7	26.8	21.8
Over 1 year	23.8	19.3	20.6	17.6	23.6	26.1	14.5	13.1	17.5
Average of all loans	64.2	53.8	42.9	33.4	31.5	27.1	22.2	20.4	27.4
<u>On deposits</u>									
Demand deposits	2.0	2.4	2.4	2.4	3.9	4.0	4.0	2.7	1.7
From 1 to 3 months	25.5	26.5	23.5	16.1	15.9	17.2	15.9	13.1	9.7
Over 1 year	20.8	23.5	26.2	16.8	22.5	15.0	15.4	12.7	11.5
Average of all deposits	27.9	20.8	9.9	8.2	9.7	10.1	9.3	5.8	3.3

Source: Bank of Lithuania.

1/ All rates are weighted averages of actual transactions; includes the State Commercial Bank, Savings Bank, and Agricultural Bank from February, 1993.

- 56 -

APPENDIX I

Table 18. Lithuania: Balance of Payments
(In millions of U.S. dollars)

	1992	1993	1994	1995
Trade balance	101	-283	-308	-334
Exports	1142	1709	1930	2210
East ^{1/}	585	993	1067	1156
Of which: energy	89	337	242	243
West ^{1/}	557	716	863	1054
Imports	1041	1992	2238	2544
East	699	1472	1513	1646
Of which: energy	338	901	664	682
West	342	520	725	898
Services (net)	-9	31	59	66
Of which: interest	9	10	2	2
Transfers	111	120	74	91
Official transfers	101	108	60	75
Private transfers	10	12	14	16
Current account balance	203	-132	-175	-177
(Without official transfers)	102	-240	-235	-252
Capital account balance	89	215	202	369
Foreign direct investment	10	23	60	55
Other private capital	--	95	125	80
Short-term credits (net)	45	-15	-81	29
Medium- and long-term loans	34	112	98	205
Other capital movements (net)	--	--	--	--
Errors and omissions	-167	72	113	-86
Overall balance	125	155	140	106
Financing:				
NFA of banking system	-125	-156	-141	-106
Central Bank	-51	-206	-193	-95
Fund financing	24	98	67	63
Reserves (- increase)	-75	-304	-260	-158
Deposit Money Banks	-75	51	52	-11
Memorandum Items:				
Current account balance (incl. transfers) in percent of GDP	11.0	-4.6	-3.1	-2.3
Total external debt				
(In millions of U.S. dollars)	94	281	448	757
(In percent of GDP)	5.1	9.8	8.0	9.7
(In percent of exports of goods and non-factor services)	7.4	14.2	19.6	29.4
Total debt service				
(In millions of U.S. dollars)	2	12	19	69
(In percent of exports of goods and non-factor services)	0.2	0.6	0.8	2.7

Sources: Lithuanian Department of Statistics; and staff estimates.

^{1/} "East" includes Estonia, Latvia, Russia and other FSU countries. "West" includes all other countries.

Table 19. Lithuania: Geographic Distribution of Trade with the East in 1995 ^{1/}

	Exports	Imports	Exports	Imports
	(Percent of total with East)		(Percent of total including West)	
Armenia	0.1	--	0.1	--
Azerbaijan	0.4	0.2	0.2	0.1
Belarus	20.8	8.1	10.8	3.6
Estonia	4.3	4.4	2.2	2.0
Georgia	0.6	--	0.3	--
Kazakhstan	2.5	1.0	1.3	0.4
Kyrgyz Republic	0.2	--	0.1	--
Latvia	13.7	7.8	7.1	3.5
Moldova	1.0	0.6	0.5	0.3
Russia	39.5	69.3	20.4	31.1
Tajikistan	0.2	0.3	0.1	0.1
Turkmenistan	0.3	0.1	0.2	--
Ukraine	14.5	6.8	7.5	3.0
Uzbekistan	1.9	1.5	1.0	0.7
Total	100.0	100.0	51.6	44.8

Source: Lithuanian Department of Statistics.

^{1/} "East" includes Estonia, Latvia, Russia and other FSU countries. "West" includes all other countries.

Table 20. Lithuania: Exports to Western Countries by Geographic Destination ^{1/}
(In percent of Western exports)

	1990	1991	1992	1993	1994	1995
Germany	12.5	13.9	16.0	20.9	27.1	27.9
Poland	14.8	13.0	13.7	21.1	11.8	7.5
Cuba	7.2	0.3	0.1	--	--	--
United Kingdom	3.0	11.3	11.4	4.7	5.4	6.1
Belgium	8.3	6.5	4.3	2.1	1.9	2.0
Denmark	1.3	7.3	7.8	4.5	4.1	5.2
The Czech and Slovak Republics	7.1	1.2	1.4	1.2	2.1	0.9
Finland	6.8	5.6	4.5	2.6	2.3	2.1
Hungary	7.6	1.4	3.0	2.7	2.1	1.0
Japan	0.1	0.2	0.4	0.2	0.2	0.1
Bulgaria	3.3	1.4	1.4	1.8	0.9	0.8
France	3.3	6.7	4.5	2.4	2.8	3.3
Sweden	1.4	8.6	9.4	5.5	7.3	4.9
Switzerland	2.4	3.3	2.7	1.2	0.5	4.2
Romania	0.8	0.7	1.2	0.9	0.5	0.3
Mongolia	1.1	--	--	--	--	--
United States	1.5	1.1	1.1	0.8	1.5	1.4
Italy	2.3	2.8	3.2	6.5	4.5	3.8
Netherlands	1.7	6.9	7.7	8.5	12.4	9.5
Viet Nam	1.8	--	0.2	3.9	0.7	0.1
Other	13.5	7.8	6.3	8.5	11.9	18.9
Total	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Lithuanian Department of Statistics; and Fund staff estimates.

^{1/} "East" includes Estonia, Latvia, Russia and other FSU countries. "West" includes all other countries.

Table 21. Lithuania: Imports from Western Countries by Country of Origin 1/
(In percent of Western imports)

	1990	1991	1992	1993	1994	1995
Germany	15.3	28.4	25.9	29.4	30.3	27.5
The Czech and Slovak Republics	11.1	1.7	1.4	2.4	5.0	3.9
Poland	9.4	11.6	5.8	6.7	8.8	7.4
Bulgaria	5.8	0.1	0.1	0.6	0.9	0.6
Hungary	6.7	1.3	1.0	1.5	1.9	1.8
Cuba	--	--	--	--	--	--
India	6.9	--	--	--	0.2	0.2
Yugoslavia	3.2	--	--	--	--	--
Romania	3.3	0.3	0.1	--	0.2	0.1
United States	3.8	5.6	15.2	3.6	4.4	3.9
Japan	3.4	0.4	1.8	0.6	0.5	0.4
Finland	1.2	3.6	4.8	3.9	6.4	6.5
United Kingdom	2.3	5.7	3.2	2.8	3.1	7.7
China	2.6	0.5	0.4	0.2	--	0.1
France	1.4	1.6	0.9	2.1	4.5	3.1
Pakistan	2.1	--	--	--	--	--
Italy	2.7	1.4	--	5.6	6.0	4.2
Switzerland	0.7	2.5	2.7	4.0	2.8	3.4
Austria	2.5	2.4	--	2.7	1.4	1.9
Sweden	1.0	8.5	6.3	3.3	5.2	5.5
Belgium	0.4	3.1	2.2	1.8	1.7	2.3
Denmark	0.3	2.8	1.4	7.4	5.7	7.1
Other	13.9	18.5	26.7	21.2	11.0	12.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Lithuanian Department of Statistics; and Fund staff estimates.

1/ "East" includes Estonia, Latvia, Russia and other FSU countries. "West" includes all other countries.

Table 22. Lithuania: Commodity Composition of Trade

<u>Commodity Group</u>	<u>Exports</u>		<u>Imports</u>	
	1994	1995	1994	1995
(In percent of total trade)				
Total	100.0	100.0	100.0	100.0
Live animals and animal products	8.9	8.4	1.6	1.3
Prepared food, beverages, and tobacco	11.9	5.6	4.3	1.3
Mineral products	16.7	11.9	32.8	26.6
Chemical products and allied industries	10.6	12.2	8.8	8.9
Textiles and textile articles	12.3	14.7	7.4	9.3
Base metals and articles of base metals	6.2	8.7	6.5	6.6
Machinery and electrical equipment	12.0	10.8	16.5	16.5
Transport equipment	3.7	5.1	6.0	7.5
Other	17.7	22.6	16.1	21.9

Source: Lithuanian Department of Statistics.

Table 23. Lithuania: Foreign Direct Investment
(In millions of litai)

	Joint Ventures			Wholly – Owned Foreign Companies		Joint Ventures and Foreign Companies		
	Number	Statutory Capital	Foreign Investment	Foreign Companies Num.	Statutory Capital	Number	Statutory Capital	Foreign Investment
Total	3,683	1,190.07	643.43	1,335	272.06	5,018	1,462.12	915.48
Industrial countries								
Finland	70	10.64	4.07	41	6.54	111	17.18	10.20
Germany	670	268.09	146.02	203	38.52	873	306.62	184.22
Great Britain	85	236.78	120.63	57	70.59	142	307.37	191.19
Sweden	87	59.00	35.02	51	4.70	138	63.69	39.60
United States	225	123.99	71.75	119	68.51	344	192.50	140.26
Eastern European countries								
Hungary	41	9.43	0.41	6	0.08	47	9.51	0.49
Poland	492	28.94	13.68	180	15.80	672	44.74	29.28
FSU countries								
Russia	866	67.92	22.78	187	17.08	1,053	85.00	39.72
Ukraine	190	32.21	11.03	41	1.35	231	33.56	12.38
Baltic states								
Estonia	109	27.34	13.01	86	0.84	195	28.18	12.29
Latvia	47	4.63	2.42	47	0.55	94	5.18	2.96
	62	22.71	9.06	39	0.29	101	23.00	9.33

Source: Lithuanian Ministry of Economics.

Lithuania--Summary of the Tax System

(as of March 31, 1996)

Tax	Tax Base	Deductions/Exemptions	Rates
1. Taxes on Income and Profits			
1.1. Corporate Income Tax	Imposed on Profits of legal persons. Profits are revenues plus miscellaneous income less costs (production costs, depreciation, interest, wages)	<p><i>Deductions:</i> Charitable Contributions, Cultural Expenses, Non-profit public organizations, etc.</p> <p>Local Governments may grant deductions and exemptions</p> <p>Government may set reduced rates for "priority" industries (i.e. agriculture is zero rated)</p>	<p>29 percent</p> <p>Rate on retained earnings: 10 percent</p> <p>Agricultural enterprises: 10 percent</p> <p>Rates for enterprises employing handicapped employees are reduced by 25-100 percent, according to number of handicapped employed.</p> <p>Rates for Foreign Investment/Joint Ventures exempt from taxation for the first three years and reduced by 50 percent for retained earnings thereafter.</p>
	Enterprises with fewer than 50 employees		50-70 percent reduced rate

1.2. Personal Income Tax	1. Wages, Salaries, Bonuses of Residents and Non-Residents (withheld at source)	Basic Deduction (BD): 173 Litai <i>Exemptions:</i> Pensions, stipends for students	Principal Job: 33 percent Second Job: .5 BD 10 percent .5-1 BD 20 percent >1BD 35 percent
	2. Royalties	<i>Exemptions:</i> 8BD	13 percent For children and old persons: 6.5 percent. For descendants: 60 percent
	3. Individual Enterprises and Partnerships		24 percent. Retained Earnings: 8 percent. Lower rates for agricultural Production.
	4. Miscellaneous Income	<i>Exemptions:</i> Interest, Dividends	20 percent
	5. Personal Business (sell)	<i>Exemptions:</i> 1BD	10 or 5 percent (depending on items sold).
2. Social Security Contributions			
2.1. Payroll Tax	Wage Bill		Employers: 30 percent Employees: 1 percent Self-Employed: 50 percent of minimum wage.

3. Property Taxes			
3.1. Land Tax	Value of Private Land	Exemptions: 1. Roads for Public Use 2. Land for Embassies 3. State-owned land, forests etc. 4. Exemptions may be granted by Local Governments	1.5 percent
3.2. Land Rent Tax	Rent on Land		3 percent
3.3. Real Estate Tax	Value of real estate owned by firms (non-incorporated and incorporated	Exemptions: 1. Diplomatic Missions 2. State-owned Enterprises 3. Non-Profit Institutions 4. Local Governments may reduce rates by 50 percent	1 percent on real estate used for business. 5 percent otherwise.
4. Tax on goods and services			
4.1. Value Added Tax	Value Added of Goods and Services	Exemptions: medicine, medical services, education, culture, postal services, newspapers, magazines, books, financial services until 1/1/97: crude oil, natural gas, nuclear fuel, coal	18 percent until 1/1/97: 9 percent for domestically produced agricultural products and food. 0 percent for exports
4.2. Excise Taxes	Tax on 19 categories of goods, including alcohol, tobacco, petroleum, coffee, luxury cars.		10-50 percent Excise Tax on gas is earmarked for road building and repairs (since 4/94).

5. Other Taxes			
5.1. Tax on Pollution	Pollutants		Rates vary with quantity and type of pollutant.
5.2. Tax on natural resources	Extraction of natural resources		Rates vary with nature, amount and quality of resources. 20 percent for domestically produced oil and gas, 29 percent if state capital is used.
5.3. Tax on assets of state-owned enterprises	Tax represents interest paid on use of state capital. Applied to total assets after bank loans, other debts and depreciation		0.5 percent
5.4. Fees and charges (stamp duty)	Registration and Recording of legal document		Specific and ad-valorem rates, depending on transaction.
6. Taxes on Foreign Trade			
6.1. Import Tariffs	Import of Goods and Services	n.a.	Three tier structure, depending on country of origin. Countries with MFN status: conventional rate. Countries with free trade arrangements: preferential rate. All other countries: autonomous rate. Rates vary widely for different product groups. All tariffs are ad valorem, except for alcohol, tobacco, and sugar.

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