Republic of Lithuania: Selected Macroeconomic Indicators

	2001	2002	2003	2004 Est.
Real Economy				
Real GDP growth (year-on-year, in percent)	6.4	6.8	9.7	6.6
CPI (end of period, year-on-year, in percent)	2.0	-1.0	-1.3	3.3
Unemployment rate (end of year)	17.4	13.8	12.4	11.3
Public Finance				
In percent of GDP				
General government fiscal balance	-1.9	-0.8	-1.7	-2.2
Total government debt	22.9	22.4	21.4	19.7
External government debt	16.2	14.8	13.5	13.2
Money and credit				
Year-on-year change, in percent				
Reserve money	8.3	20.8	26.6	7.1
Broad money	21.4	16.9	18.2	24.1
Private sector credit	6.3	30.4	58.8	39.8
Balance of Payments				
In percent of GDP				
Trade balance	-9.2	-9.5	-9.3	-10.5
Current account balance	-4.7	-5.2	-7.0	-8.6
Gross official reserves (in millions of U.S. dollars)	1,669.2	2,412.8	3,449.7	3,594.0
Exchange Rates				
Litas per U.S. dollar				
Exchange rate (period average)	4.0	3.7	3.1	2.8
Exchange rate (end period)	3.6	3.4	2.8	2.5

Sources: Lithuanian authorities; and IMF Staff estimates.

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Statement by Jon A. Solheim, Executive Director for Republic of Lithuania and Giedrius Sidlauskas, Advisor to Executive Director
March 23, 2005

On behalf of our Lithuanian authorities, we would like to express our appreciation to the staff for the constructive discussions in Vilnius and for an interesting and useful set of papers for the 2004 Article IV consultation. Though the authorities broadly share staff's analysis and recommendations, their latest official growth forecasts are more cautious than staff's with important consequences for the assessment of the fiscal policy stance.

Following a prolonged period with stability-oriented macroeconomic policies and far reaching structural reforms, Lithuania became member of the European Union on May 1, 2004, making this the first Article IV consultation with Lithuania as an EU member. The authorities take an active part in the current activities of the EU, and bring an example of rapid reforms and flexibility. Over a very short period of time, Lithuania had to harmonize laws with EU legislation and rebuild the economy in order to be able to operate under free market conditions. This required political will and flexibility, as well as determination of the Lithuanian people to accept difficult and sometimes painful reforms.

While one important milepost has been passed with the EU membership, our authorities are well aware that this achievement is not reason for complacency and that many challenges lay ahead, including important short-term risks as noted by staff. The Lithuanian authorities remain fully committed to ensure continued rapid real and nominal convergence with the economic and social standards of the EU. Above all, the Lithuanian authorities are firmly committed to ensure policies consistent with their objective of joining the Euro Area by January 1, 2007, as further elaborated in the January 2005 update of the convergence program of Lithuania.

Growth in Lithuania has remained brisk, resulting in continued catching up with the Euro Area average. In 2003, growth reached one of the highest levels in the world - 9.7 percent - and in 2004 settled to a level closer to the long-term growth potential with 6.7 percent growth. The authorities have taken a prudent stance in projecting future GDP growth and adjusted fiscal policy accordingly to preserve their fiscal consolidation targets. The macroeconomic scenario in the authorities' updated convergence program from January 2005 shows real GDP growth of 6.5 percent in 2005 and a slightly decelerating growth thereafter to 6 percent in 2007, whereas staff, as noted in their report, expects even stronger growth, that could reach 7 percent in 2005. Further economic growth is expected to be supported by robust domestic demand and some fiscal stimulus due to government co-financing of transfers from the EU, which are projected in the order of 3.4 percent of GDP in 2005 and 4.4 percent of GDP in 2006. The ECOFIN Council in its opinion of March 8, 2005 found the authorities' macroeconomic scenario to reflect plausible growth assumptions.

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Fiscal Policy

The key objective of the medium-term fiscal strategy is the approximation to a cyclically balanced general government budget in line with the principles of the Stability and Growth Pact.

Preliminary figures show a general government deficit in 2004 of 2.5 percent of GDP, i.e. lower than the 2.7 percent budgeted in May 2004, thanks to better than expected revenues. At the same time, our authorities have decided to maintain their deficit targets for 2005-07, despite the downward revision of GDP growth, thereby emphasizing the importance they attach to continued ambitious fiscal restraint. The authorities foresee the general government deficit to remain at 2.5 percent of GDP in 2005 and to decline gradually to 1.8 percent in 2006 and 1.5 percent in 2007. Consolidation is planned to be achieved mainly by a continued increase of revenues from a low base and, from 2005, also the expenditure side contributes. A significant public investment program is being implemented, which lifts public investments from 3.4 percent of GDP in 2004 to 5 percent in 2007.

Our authorities very much appreciate the constructive dialogue with staff on fiscal policy challenges and staff's useful specific advice, including from the Fiscal Affairs Department. While being in broad agreement with staff's recommendations, our authorities would like to emphasize that a possibly higher GDP growth rate, as expected by staff, does not necessarily make it easier to implement the necessary strict fiscal consolidation policy. Too optimistic GDP growth and public revenue projections could complicate their efforts to introduce measures to compensate for an abolishment of the Road Tax and provide room for future cuts in personal income taxes. Lower taxes are seen as important in order to suppress Lithuania's shadow economy and provide better conditions for the implementation of the authorities' social policy.

In case growth would be stronger than projected due to higher EU transfers, additional pressure would be put on the fiscal deficit reduction efforts as the government would incur higher co-financing expenditures that cannot be compensated for through higher tax revenues.

In assessing the overall soundness of fiscal policy, due account must be devoted to the public debt, which declined to 19.7 percent of GDP in 2004, with long-term debt accounting for 94 percent of the debt. In the medium term, general government debt should settle at about 20 percent of GDP. Government debt guarantees have stayed at about 2 percent of GDP and are expected to decline to 1.2 percent of GDP over the medium term. No guarantees on new loans have been issued since 2003. As a further element of prudent fiscal policy, the government has accumulated funds in the Stability Fund corresponding to 1.7 percent of GDP, which could be drawn upon in case of need to cover the government's liabilities in the event of unattractive borrowing conditions in the financial markets. The authorities are fully aware that to prepare for an ageing population is important in their fiscal planning. However, the relatively low debt ratio and a successful introduction of a third pension pillar puts Lithuania in a relatively good position to address these and other social policy challenges.

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The authorities are ready to maintain the good track record in meeting fiscal targets and to redistribute expenditures to meet budget deficit limits in case co-financing of the EU projects will require more funds than allocated in the budget. The authorities are committed to follow the EU Broad Economic Policy Guidelines (BEPG) and to direct extra budgetary revenues for further reduction of the fiscal deficit. Above all, they are fully committed to a fiscal policy stance consistent with their objective of joining the Euro Area in 2007. They are cognizant that to achieve a high degree of sustainable convergence, it will be necessary to ensure a sound fiscal consolidation path and an environment conducive to price stability.

Monetary and Exchange Rate Policy

Lithuania joined ERM II at the end of June 2004. Following a careful assessment by the ERM II authorities, it was supported that Lithuania would join the exchange rate mechanism with the standard fluctuation band, but with its existing currency board in place as a unilateral commitment. The experience of more than a decade of fixed exchange rate policy proved that a fixed exchange rate is a valuable anchor for macroeconomic stability and non-inflationary economic growth.

The litas has not deviated from its central rate vis-à-vis the euro, and the continued high confidence in the exchange rate policy is reflected in low and relatively stable interest rate differentials to the Euro Area. In fact, the short-term interest rate differential against the three month EURIBOR has been small and continued to decline since the ERM II entry (from almost 0.6 to around 0.4 percentage points at the end-2004). Long-term interest rates of relevance for the convergence assessment have been below 5 percent since ERM II entry, and have stayed significantly below the reference value for the interest rate convergence criteria. Furthermore, the recent eleven-year Eurobond issue was heavily oversubscribed with a record low interest rate and a yield spread of only 22 basispoints above comparable German government securities. Taken together, these indicators are clear evidence of financial markets' high confidence in the authorities' commitment to a continued strong macroeconomic track record.

The authorities recognize that also legal changes for the central bank are necessary before Lithuania can join the Euro Area. In December 2004, the Bank of Lithuania approved an action plan with respect to the adoption of the euro covering the next two years, including an outline of the necessary measures for the alignment of the legal framework.

Our authorities concur with staff that short term risks concerning inflation need close monitoring. They stand ready to adjust economic policies as appropriate to maintain an environment conducive to price stability consistent with their objective of joining the Euro Area in 2007. The continuous boom of oil prices, rising food prices and changes in administered prices, as well as adjustment of indirect taxes to promote convergence within the EU, led to a reversal of an almost two-year period with negative inflation. Inflation through 2004 is estimated at 2.9 percent (average annual inflation 1.2 percent) and is forecasted to stay at 2.9 percent in 2005, before declining to 2.5 percent in 2006 according to the convergence program. In February 2005, inflation reached 3.3 per cent amid rising oil prices, which influenced relatively strongly Lithuania's price developments. The latter is partly due to the fact that the weight of energy items in Lithuania's HICP is almost two times

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