

**Republic of Lithuania: Request for Stand-By Arrangement—Staff Paper; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Lithuania**

In the context of the Request for Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff paper for the Request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **May 15, 2001**, with the officials of the Republic of Lithuania on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on August 9, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Press Release summarizing the **views of the Executive Board as expressed during its August 30, 2001 discussion** of the staff report that completed the request.
- a statement by the Executive Director for the Republic of Lithuania.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF LITHUANIA

**Request for Stand-By Arrangement**

Prepared by European II and Policy Development and Review Department

Approved by Mohammad Shadman-Valavi and Liam P. Ebrill

August 9, 2001

- Discussions were held in Vilnius during April 30-May 15, 2001 with the previous government, and continued in July with the new government. The Fund staff team comprised P. Alonso-Gamo (head), S. Fabrizio, S. George, V. Kramarenko (all EU2), and Q. Wang (PDR), and was assisted by M. Horton, the Fund's resident representative. Mr. O. Lehmussaari, Executive Director, attended some policy meetings. Mr. Odling-Smee met high-level officials during May 9-11.
- On March 8, 2000, the Executive Board approved a 15-month Stand-By Arrangement (SBA) for an amount equivalent to SDR 61.8 million (42.6 percent of quota), and the last review was completed on a lapse-of-time basis on April 16, 2001. The precautionary arrangement expired on June 7, 2001.
- In the attached letter dated July 26, 2001, the authorities request a new 19-month SBA (Attachments I and II) for an amount equivalent to SDR 86.52 million (60 percent of quota). The authorities have indicated that they do not intend to make purchases under the arrangement. The requested arrangement supports the policies and measures for the period July 2001-December 2002, outlined in the accompanying Memorandum of Economic Policies (MEP), which the authorities intend to publish. The first review and the Article IV consultation are expected to be completed by December 2001.
- Lithuania has accepted the obligations of Article VIII of the Fund's Articles of Agreement and maintains an exchange system free of restrictions on payments and transfers for current international transactions.
- Relations with the Fund and the World Bank are summarized in Appendixes I and II, respectively; technical assistance by the Fund is described in Appendix III; periodicity and timeliness of the most important statistics are presented in Appendix IV; Appendix V describes the medium-term fiscal framework.

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## I. INTRODUCTION

1. Despite the fragmented political environment in Lithuania, clear support for European Union (EU) and NATO accession across the political spectrum has allowed for continued and steady progress in reforms. On June 19, 2001, the liberal-centrist government led by Prime Minister Paksas unanimously endorsed an economic program that had been discussed during a Fund staff visit to Vilnius in May.<sup>1</sup> However, shortly after having signed the Letter of Intent, the government, which had a very narrow parliamentary majority, collapsed. The social democrat party, supported by the social liberal party, was able to form a majority government, in which six out of thirteen Ministers from the previous cabinet were retained. The newly-appointed government led by former President Brazauskas stressed continuity and reiterated its commitment to the major goals of the previous government, the maintenance of fiscal restraint, and the pursuit of the reforms spelt out in the accompanying MEP.

## II. RECENT ECONOMIC DEVELOPMENTS AND PERFORMANCE UNDER THE PREVIOUS PROGRAM

2. **Under the previous SBA, Lithuania achieved significant progress in macroeconomic stabilization and structural reforms**, and greatly improved its prospects for EU membership in the first wave of expansion (Tables 1-12). All performance criteria for end-March 2001 were met, except for the elimination of expenditure arrears of the central government, which was missed by a very small margin (Tables 8-9 and Box 1).

3. **All macroeconomic objectives under the previous program were attained.**<sup>2</sup> In 2000, real GDP grew by 3.3 percent, compared with the previous estimate of 2.7 percent (Table 1 and Figure 1). The recovery was underpinned mainly by export growth, while domestic demand declined by 0.2 percent. The external current account deficit shrank sharply from 11.2 percent of GDP in 1999 to 6.0 percent in 2000, mainly reflecting strong export growth and the demand-containing effects of the fiscal adjustment (Table 3). In the first

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<sup>1</sup> The mission met with President Adamkus, former Prime Minister Paksas, Bank of Lithuania (BoL) Governor Šarkinas, Seimas Chairman Paulauskas, Seimas Budget and Finance Committee Chairman Glaveckas, members of the previous government Minister of Finance Lionginas, Minister of Economy Gentvilas, Vice Minister of Finance Jonikas, Vice Minister of Labor and Social Protection Morkuniene, as well as other senior government officials, members of Parliament, and representatives of the banking and business communities and of trade unions.

<sup>2</sup> The international rating agency Fitch IBCA, Duff & Phelps announced on May 16, 2001 that due to the considerable improvement in Lithuania's economy over the previous 18 months it was raising the country's long-term foreign currency rating from BB+ to BBB-. Standard & Poor reaffirmed their rating at BBB-.

### **Box 1. Lithuania—Structural Conditionality**

#### **1. Proposed Coverage of Structural Conditionality in the Program**

Structural areas covered by conditionality in the proposed program are: (i) fiscal reforms (municipal finances, pension reform, regulation of usage of privatization receipts); (ii) financial sector reform (bank privatization); (iii) labor market policies to address unemployment; and (iv) business environment. Structural policy benchmarks (MEP, Table 3) focus on actions considered essential to macroeconomic stability and an efficiently functioning market economy, because of their relevance for supporting the targeted budget adjustment, enhancing financial sector efficiency, and fostering private sector activity. Issues outside of the Fund's core areas, such as labor markets and private sector development, which are covered by conditionality under the program because of their macroeconomic impact in the medium term, are also monitored by the World Bank consistently with the Fund program.

#### **2. Status of Structural Conditionality from Earlier Program.**

Under the last stand-by arrangement, structural conditionality was set in the following areas: (i) fiscal reform; (ii) financial sector reform; and (iii) energy sector reform. Progress under (i) and (ii) was broadly satisfactory, although bank privatization took longer than originally envisaged. Progress was also recorded in the restructuring of the finances of the energy sector enterprises, but the privatization process is lagging behind. Measures in the energy sector reform are not included in the proposed program because financial viability of energy utilities has been restored and their privatization will have a macroeconomic impact only in the long run. The World Bank staff, better placed to monitor and advise in this area, is taking the lead. Nonetheless, the Fund will continue to monitor the macroeconomic impact of measures taken in this area.

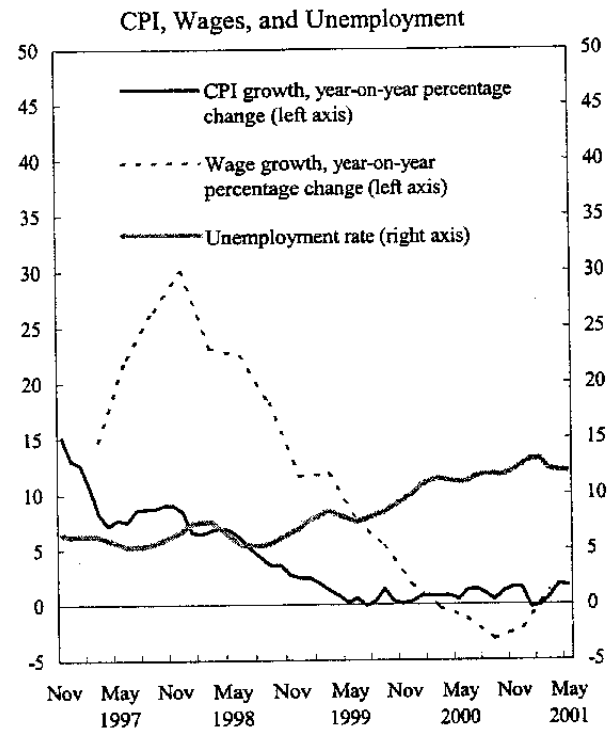
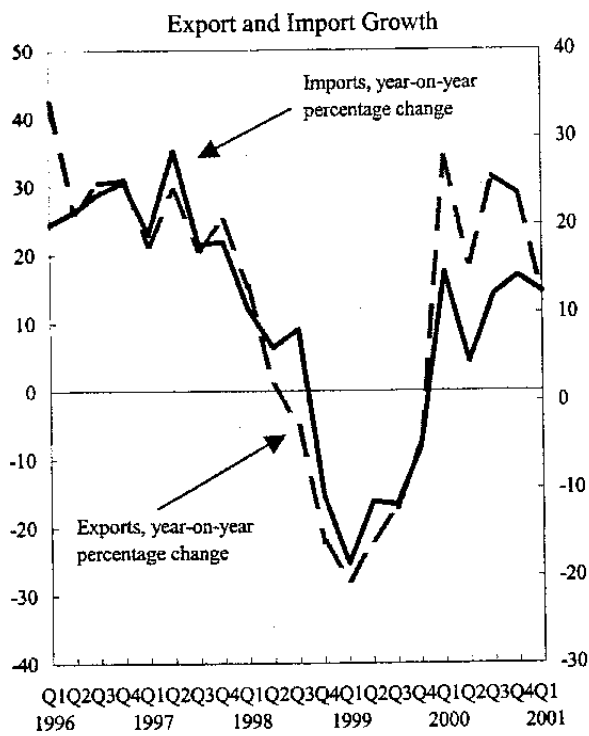
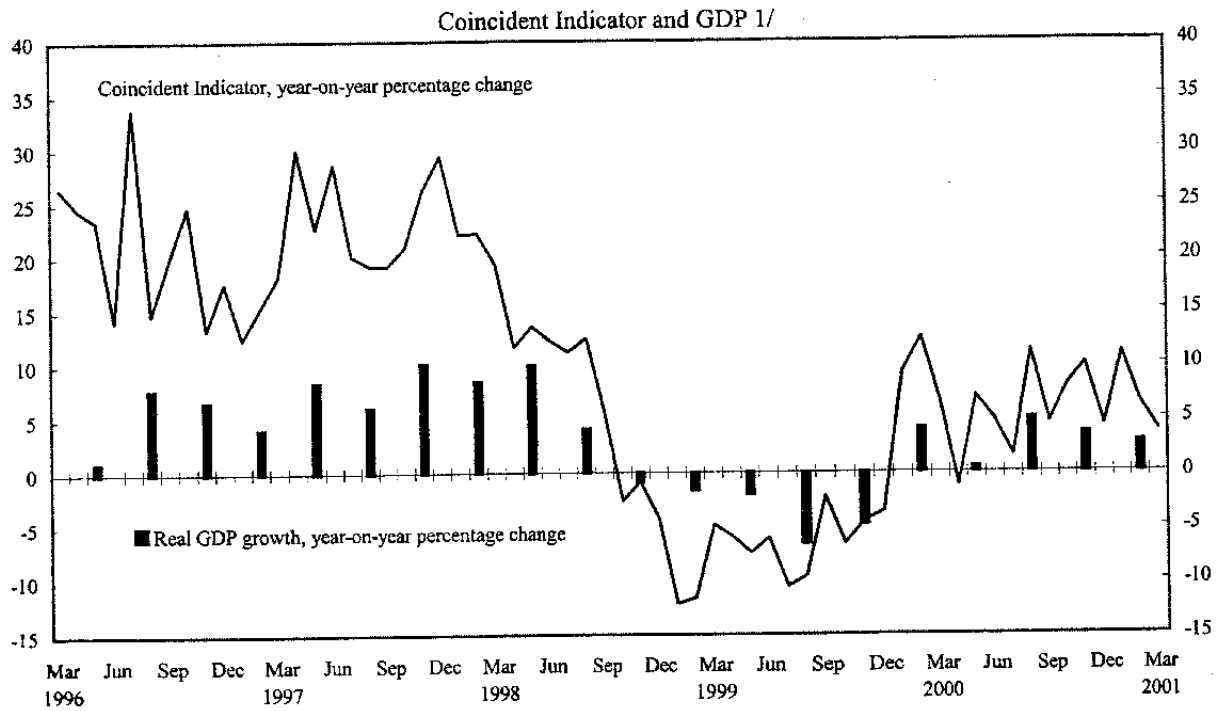
#### **3. Structural Areas Covered by Bank Lending and Conditionality**

Structural areas covered by the World Bank through a Structural Adjustment Loan (SAL II) and several projects (Appendix III) include: (i) budget management, (ii) pension reform, (iii) unemployment and social safety nets, (iv) private sector development, (v) infrastructure, (vi) energy sector reform, and (vii) agriculture. Staff has closely cooperated with the Bank on the issues of common interest in these areas.

#### **4. Other Relevant Structural Conditions not Included in Current Program.**

There are no direct structural conditions related to agriculture, for several reasons: (i) because improvement in this area will be only gradual and in the medium term, as, after reducing and rationalizing government involvement in agriculture, the sector as a whole needs to be restructured; and (ii) other agencies, in particular the EU and the World Bank are taking a leading role on this area. Moreover, a number of structural measures in the business and regulatory environment, which are needed to meet EU standards, are not part of the program and will be followed by the EU, so that Lithuania can remain competitive and take full advantage of the benefits of joining the EU.

Figure 1. Lithuania: Selected Economic Indicators, 1996-2001



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

quarter of 2001, real GDP grew by 4.4 percent year-on-year, led by continued strong export growth and a pick up of domestic demand, which increased by 5.6 percent with respect to the first quarter of 2000. Private consumption grew by 5.5 percent, while total investment increased by 14.6 percent. The current account deficit was about 6.5 percent of GDP, with exports and imports of goods growing at about 17 and 14 percent in U.S. dollar terms, respectively. The increase in imports suggests a pick-up of domestic demand. After a depreciation of 6 percent in November 2000-January 2001, the real effective exchange rate has appreciated recently, reflecting some weakening of the euro (Figure 2).

4. **Prices and wages increased modestly in the first months of 2001, and unemployment rate started to decline in April for the first time in the last year.** The year-on-year CPI and PPI increased by 1.7 and 2.9 percent in May 2001, respectively, reflecting mainly the raise of oil and food prices. Average wages declined by 3 percent in the first quarter of 2001 with respect to the last quarter of 2000, although they increased by 1.2 percent year-on-year. The unemployment rate declined in June for the third consecutive month, reaching 12.1 percent.

5. **After significant fiscal consolidation in 2000, when the general government deficit was reduced from 8.5 percent of GDP to 2.8 percent, public finances continued to improve in the first quarter of 2001 (Table 2).**<sup>3</sup> The general government deficit for the first quarter of 2001 amounted to LTL 97 million (0.3 percent of annual GDP less than programmed). Revenue performance of the general government was broadly in line with program projections.<sup>4</sup> Expenditure in the first quarter of 2001 was below projections, mainly on account of delays in approving the public investment program. In addition, cash expenditure of municipalities was constrained by a shortfall in the personal income tax (PIT) collection—their main source of revenue. Expenditure of the Social Insurance Fund (SoDra) was below projections due to lower compensation for work accident insurance and pensions. In July Seimas approved a revision of the national budget for 2001, which aims mainly at reallocating expenditure while keeping the budget deficit target of 1.4 percent of GDP unchanged (MEP, paragraph 12).

6. **Central government expenditure arrears declined in the first half of 2001 by 0.1 percent of GDP,** although the program performance criterion to eliminate them completely by end-March was missed by a narrow margin (less than 0.1 percent of GDP). Central Government arrears remained at the same level at end-June. The Road Fund eliminated its expenditure arrears. However, LTL 14.6 million of state budget arrears remained at end-June, despite the Treasury

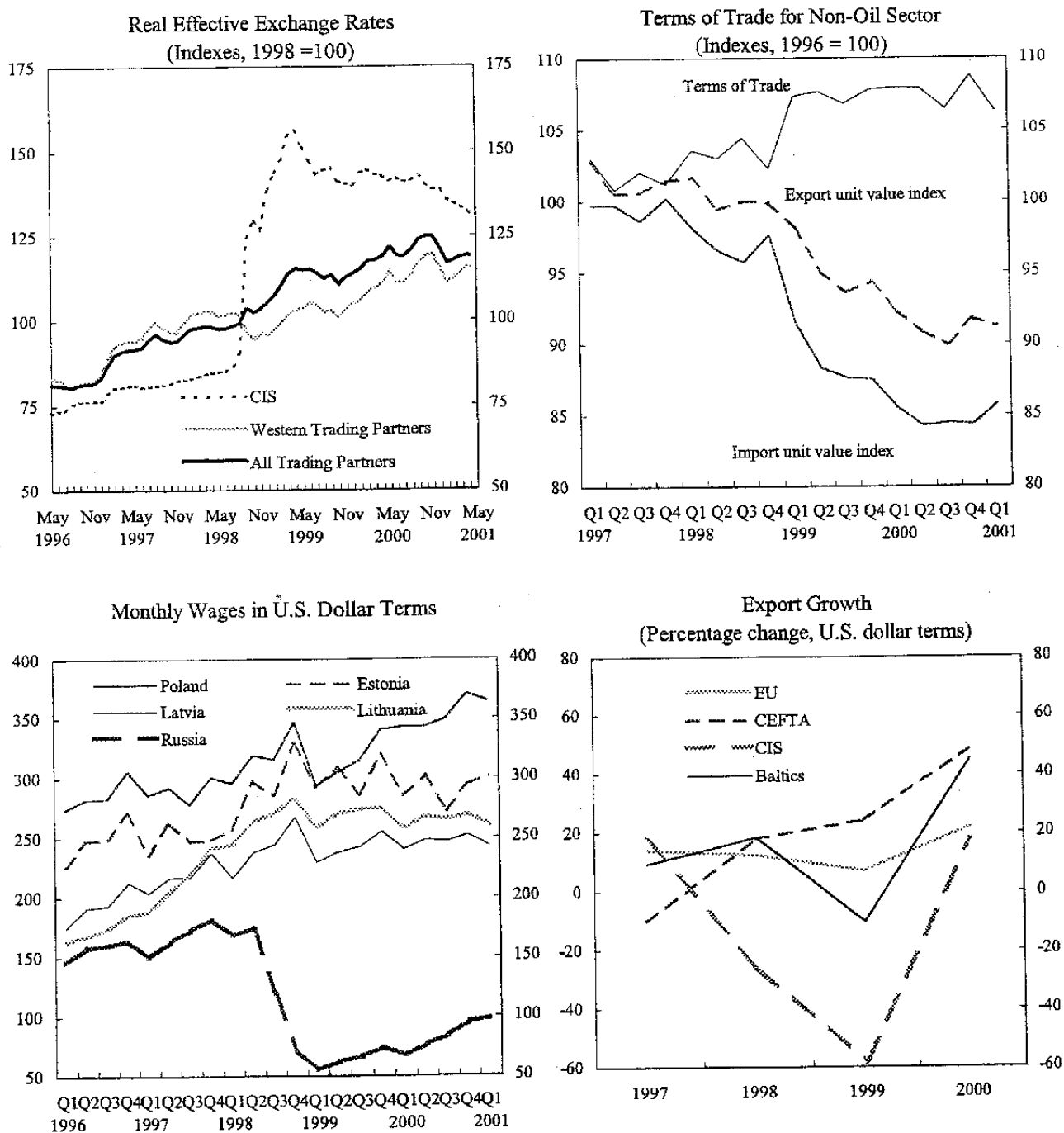
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<sup>3</sup> The 2000 fiscal consolidation was achieved through significant cuts in net lending to Mazeikiu Oil Company, the postponement of the savings restitution program, an across-the-board reduction of spending on goods and services, and an increase in the payroll tax from 31 to 34 percent.

<sup>4</sup> Shortfalls in the payroll, personal income, and value added taxes were almost offset by better performance of excises and nontax revenue.



Figure 2. Lithuania: Indicators of External Competitiveness, 1996-2001

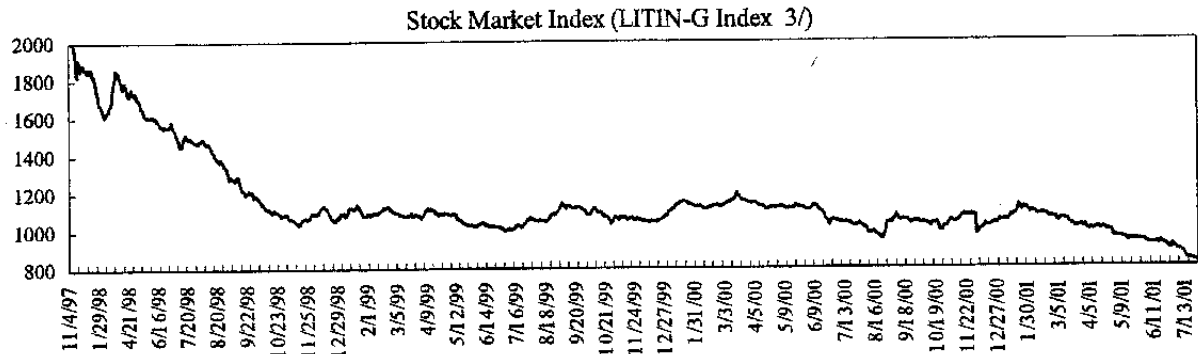
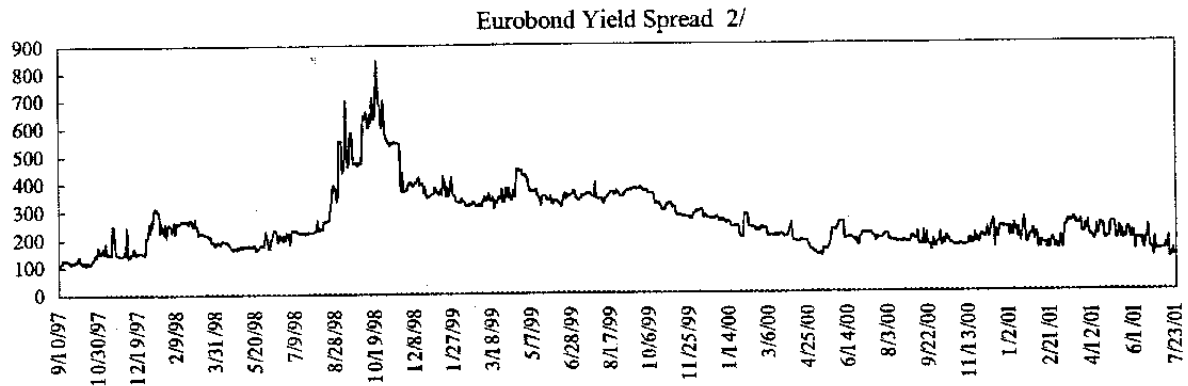
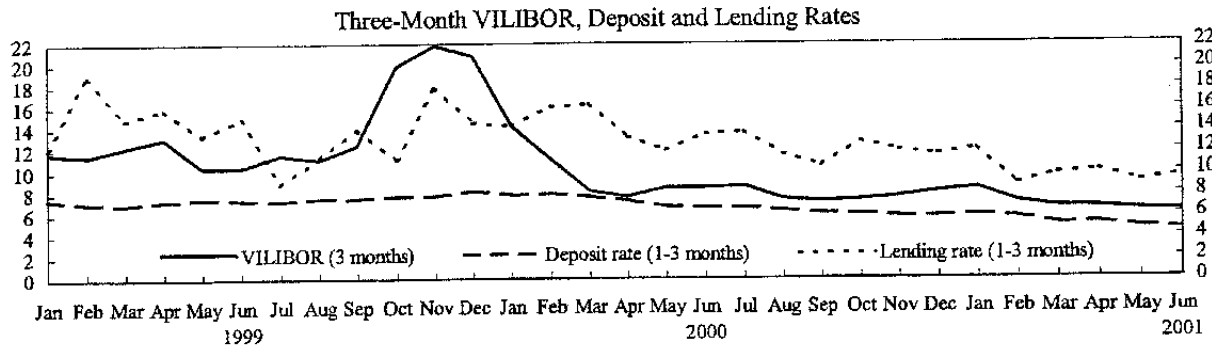
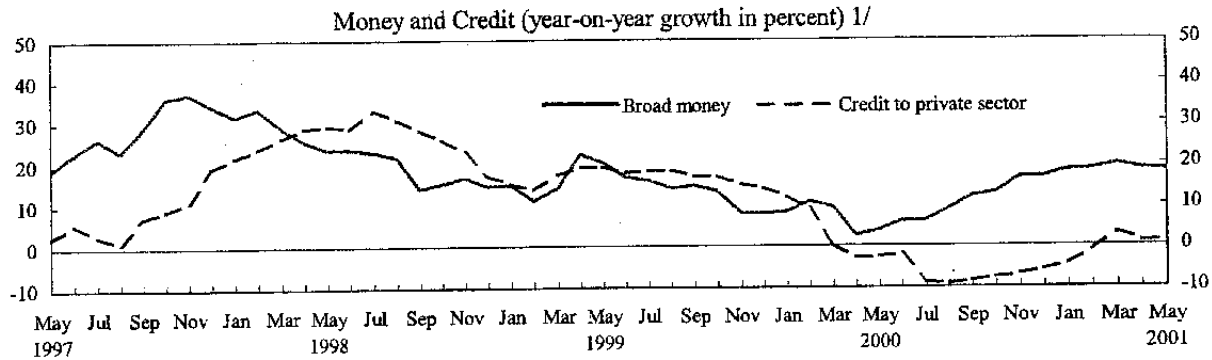


Sources: Lithuanian authorities; and Fund staff estimates.

having allocated sufficient funds for payment of current obligations and outstanding arrears. This was attributable to poor expenditure control, planning and coordination of the very large number of state budget appropriation managers. Arrears of the Health Insurance Fund (HIF) declined from LTL 23 million at end-December 2000 to LTL 5 million at end-June.

7. **The shortfalls in the PIT and expectations of a bail-out led to an increase by LTL 22 million (0.1 percent of GDP) of expenditure arrears of municipalities in the first half of 2001.** Municipalities continued to lobby for compensations for a long list of the unfunded obligations which they argued were imposed by the central government from 1997 to 2001. Municipalities maintained that they had to finance unfunded obligations by delaying cash payments for other expenditures. Arrears were mainly incurred to municipal utility companies, the Lithuanian Power Company, and recipients of allowances. More than 50 percent of arrears were incurred by a few municipalities. These municipalities also incurred arrears on transfers of withheld personal income and payroll taxes of municipal employees to the State Tax Inspectorate (STI) and SoDra, thereby undermining finances of the municipalities receiving transfers from the Equalization Fund and SoDra.
8. **Progress was made in fiscal reform.** In April 2001, the Ministry of Finance established two new departments to coordinate and monitor financial issues related to EU accession, including mobilization of cofinancing. A new draft Law on Tax Administration, streamlining procedures for penalties, arrears write-offs and tax deferrals, was submitted to Seimas in April. Important reforms of the Treasury system (software upgrade, creation of a single Treasury account, and direct payments for most agencies) were also implemented.
9. **Greater confidence in the banking system led to larger-than-expected broad money growth of 19.4 percent year-on-year in the first quarter of 2001 mainly on account of the increase in deposits** (Table 4, Figure 3, and Box 2). After falling in 2000, credit to the private sector started picking up again, and grew by 3 percent year-on-year, while investment abroad continued with a further buildup of commercial banks' net foreign assets by LTL 353 million in the quarter, as banks did not find a sufficient number of projects to finance domestically. Data to June show similar trends in the monetary aggregates. Interest rates in both nominal and real terms continued to fall (Figure 3), reflecting the decline in U.S. interest rates, increased confidence in the financial system and the currency board, and abundant liquidity in the system. Real interest rates fell from 14.6 percent in early 2000 to 10 percent in the first quarter of 2001, but still remain very high.
10. **The privatization of the Savings Bank was concluded,** with the sale effective as of June 1, 2001. The authorities had authorized its purchase by Hansabank, reserving the right to request for divestiture of one of the banks if the parents of Hansabank and Vilnius Bank (Swed and SEB, respectively) merge. The tender winner for advisors to prepare the Agricultural Bank for privatization was PriceWaterhouseCoopers.

Figure 3. Lithuania: Financial Indicators, 1997-2001



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

1/ Included are reclassification of 270 million of DMB's claims on private sector to government lending funds, which were removed from banks' balance sheets in July, 2000.

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

3/ Calculated from all issues quoted in the current trading list, excluding treasury bills and investment companies.

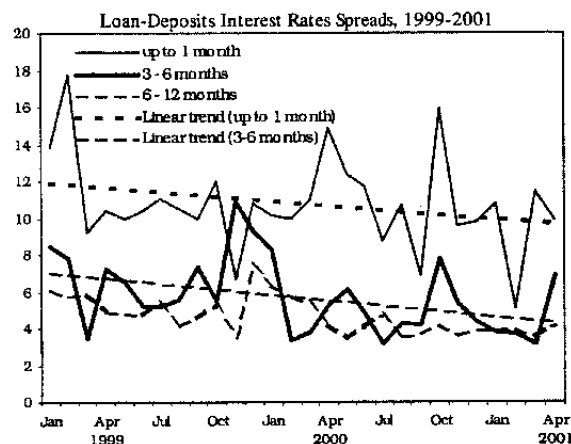
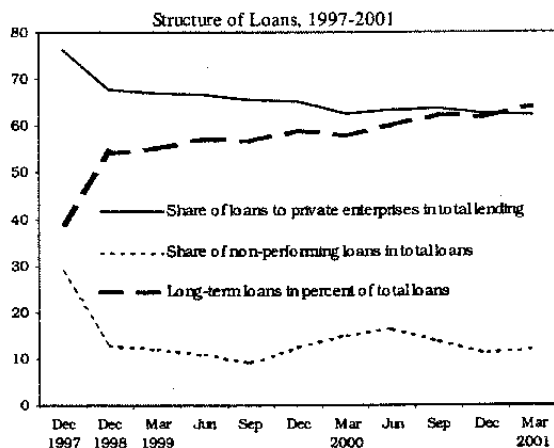
## Box 2. Banking Sector Issues

The banking sector consolidated after the financial crises of 1995-96, when the number of banks fell from 28 in early 1994 to 12 at end-1995. Although direct exposure of the banks to the Russian crisis of 1998 was minimal, the indirect effects from the sharp dip in growth in 1999 have been pronounced, affecting the willingness of banks to engage in credit activity. Even as the financial sector has deepened and monetization has increased over the past three years, financing of private sector activities from the banking sector has remained sluggish, with private sector credit (excluding write-offs) falling by 1.2 percent in 2000, while real GDP grew by 3.3 percent. Another reason for this apparent malaise was further consolidation of the banking sector, and aggressive restructuring and provisioning in preparation for privatization of three state banks.

### Structure of the Sector

As of the first quarter of 2001, the banking sector comprised ten commercial banks of which only one remained majority state owned, together with four branches of foreign banks, and an asset-workout bank, totaling assets of LTL 13.6 billion (from LTL 8.9 billion in early 1998). The newly privatized Savings Bank, which has assets of LTL 3.7 billion, combined with the smaller Hansabank, will have assets of roughly around LTL 4 billion. The remaining state bank, the Agricultural Bank with assets close to LTL 1.8 billion, will be prepared for privatization by PriceWaterhouseCoopers by early fall. The assets of the largest private commercial bank Vilnius Bank, a local subsidiary of the Swedish parent SEB, amount to LTL 5.4 billion, 40 percent of the total assets of the banking system.

**Structure of loans.** Loan growth and composition of loans improved, although in 2000 there was more consolidation than growth until late in the year (see left chart below). Intermediation improved as long-term loans (over one year) as a proportion of total loans increased from less than 40 percent in 1997 to more than 60 percent in 2000. Loans extended to private enterprises rebounded by 2.4 percent in the fourth quarter of 2000 (q-o-q), and by 6.1 percent in the first quarter of 2001 (y-o-y), even though the share in total loans remained below 1997 levels (Table 12). Average interest rates on loans also fell in the period. For example, interest on loans of up to one month to enterprises in litas after having reached 14.05 percent in the first quarter of 2000, has fallen to 10.9 percent by end-2000. Moreover, spreads between deposit rates and lending rates have also fallen indicating increased efficiency of the banking system (see right chart below).



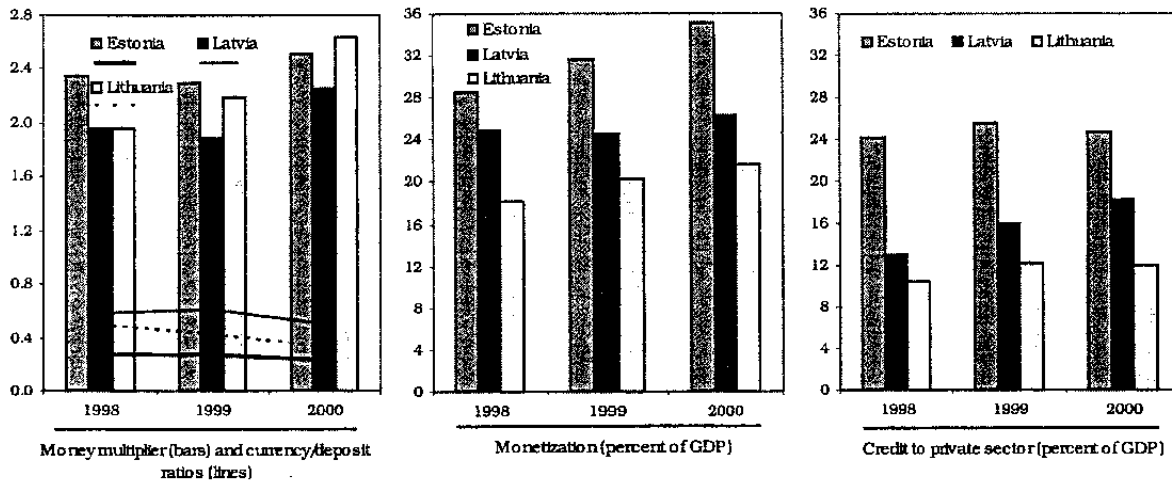
**Structure of deposits.** Deposits increased more than 60 percent from 1998 till the first quarter of 2001 increasing from LTL 6 billion to LTL 9.7 billion. Deposits were 77 percent of broad money, increasing 10 percentage points in the same period. The share of demand deposits in the same period fell almost 20 percentage points from 67 percent to 47 percent. Although the share of foreign currency deposits increased by 10 percentage points, it remained fairly stable for the last year and a half.

### Main Issues

- **Competitiveness of the banking sector.** The sector has been fairly concentrated, with the state banks unable to provide enough competitive pressures especially with regard to finding loan opportunities. Though sources of funds have not been the bottleneck, savers have few instruments. Increased competition between banks would increase mobilization in the long-term. More liberal rules with the voluntary third pillar of pension reform should also harness greater savings.

- Capacity of intermediation.** A banking system that provides effective financial intermediation mobilizes savings, as well as ensures that the highest return investment projects are financed. To analyze the effectiveness of the banking sector in Lithuania, we examine 3 indicators of intermediation, and compare them with the other two Baltic countries (see chart below). The *money multiplier* increased from 1.95 in 1998 to 2.64 in 2000, reflecting not only a reduction of required reserves, but also a substitution away from currency in transactions (Table 4). This is slightly higher than either in Estonia or Latvia. *Monetization* of the economy, measured as the ratio of broad money to GDP, increased from 18 percent in 1998 to 22 percent in 2000, again showing more confidence in the financial system, although it was less than in Estonia and Latvia, where the economies have been growing more robustly as well. *Credit to the private sector* relative to GDP stayed more or less flat going from 11 percent in 1998 to 12 percent in 1999, and stagnating in 2000. Lithuania's financing from the banking system was 50 percent less than Estonia, and 33 percent less than Latvia.

Baltic Countries: Capacity of Intermediation, 1998-2000



An effective interbank market would also generate efficiencies of intermediation by allowing banks to hold less precautionary excess reserves, and support higher loan activities. The volume of total transactions in litas fell from the quarterly average of LTL 900 million in 1999 and LTL 535 million in the first quarter of 2001. Interest rates in the same period also fell (Figure 3). On November 13, 2000, the BoL started daily reporting of the liquidity of the financial system, which by its transparency should further develop the interbank market, and reduce excess reserves. Currently, the BoL is examining ways to streamline cumbersome collateral requirements.

- Banking supervision and prudential regulations.** Banking supervision has improved since 1997 and prudential regulations have converged to Basle and EU standards, with a comprehensive CAMELS (Capital, Assets, Management, Earnings, Liquidity, and Sensitivity) rating system used to evaluate commercial bank and subsidiary loan portfolios. Branches are supervised by the parent country. On-site inspections are conducted on an annual basis, while off-site submissions are made monthly. Non-performing loans fell to 11.2 percent as a share of total loans in the fourth quarter of 2000 (Table 12). The up tick of non performing loans to 12 percent in the first quarter of 2001 coincides predictably with the timing of the on-site inspections. Capital adequacy requirements were aligned with Basle methodology in 1997, and the risk-weighted capital asset ratio remains above the required 10 percent at 16.4 percent. In case the risk-weights are in doubt, the unweighted capital to total asset ratio was 9.2 percent. Open positions in foreign exchange including off-balance items were also well within legal limits, even though there may still be credit risk exposure originating from the large proportion of foreign currency loans (almost 2/3 of total loans).

**Issues for further development of banking sector**

Despite improvements in recent years, greater capacity of intermediation of the banking system is needed for the economy to move to a higher steady-state growth path. The privatization of the remaining state bank would not only increase competition and most likely foreign participation, but also would reduce the uncertainty resulting from the long-pending privatization process. Furthermore, a more robust economy would promote further development of the financial system, as well as increase credits extended to the private sector, which is already becoming evident from the upturn of loans both to individuals and enterprises in the fourth quarter of 2000. In preparation for EU accession, a Financial Sector Assessment Program has been requested by the authorities, and it is scheduled for this fall.

11. **The BoL announced on June 28 that it will proceed with the repegging of the anchor currency from the dollar to the euro on February 2, 2002**, based on the European Central Bank (ECB) reference exchange rate of the euro for the dollar of February 1, 2002. The announcement was well-received by the markets. The repegging is planned in view of the progressive orientation of trade toward the euro area and greater economic integration with the region. The BoL has been consulting with the ECB and the Fund staff regarding the technical aspects of the repegging. The government also completed the transfer of its Treasury accounts from commercial banks to the BoL on June 30, 2001. The BoL is working together with the Ministry of Finance to improve forecasts of Treasury flows, using historical data.

12. **In the first half of 2001, good progress was made in improving the business environment and fostering private sector activity.** The sunset and the sunrise commissions were revived, with the former established as the institution to formally monitor administrative barriers.<sup>5</sup> The market regulation system was streamlined, with the centralization of all business inspection functions in two main agencies. The bankruptcy law and amendments to the labor law were passed by Seimas in March. With regard to privatization, the Lithuanian Shipping Company (LISCO) was sold to a Danish firm in April. In May, a public tender for the advisor on privatization of the Lithuanian Airlines was announced, and a plan for the reorganization of the Lithuanian Railways was approved by the government. Residual government shares in one hundred small enterprises were sold in March-April. On May 31, Lithuania became a member of the World Trade Organization (WTO).

13. **Despite the government's efforts, insufficient progress was made in the restructuring of the energy sector**, owing to political disagreement at the parliamentary level (Box 3). Nonetheless, the financial situation of energy public enterprises strengthened following tariff increases. In June 2001, the Mazeikiu Nafta Oil Company, which had made losses in 2000 and the first quarter of 2001 due to disruptions in oil supplies, reached a long-term agreement on oil supplies with a Russian company (Box 3).

14. **Some progress was made in 2000 to rationalize and reduce agriculture subsidies.** Market intervention in the form of price support remains only for grain, while trade is now regulated by WTO rules. The reduction of government support has led to needed consolidation of key processing and export sectors but also to protests by farmers. Seventy five percent of trade is conducted under free trade agreements or most favored nation conditions, including with Russia and other CIS countries, while most tariffs are below the binding rates for the WTO. Despite this progress, little was done in improving the state food market regulatory agency and market regulation policies. This together with insufficient progress of restructuring the energy sector led to a delay in the disbursement of the second tranche of the World Bank's structural adjustment loan (SAL).

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<sup>5</sup> They were established in 2000 to target the removal of obstacles for commercial activity, streamline public administration, and put in place a more flexible regulatory environment.

### Box 3. Energy Sector Issues

#### Background

The energy sector in Lithuania, comprising electricity, gas, and oil transit and refining, has been beset by problems whose origins go back to the pre-independence era, including overcapacity in oil and electricity sectors, and weak operational and financial conditions, leading to fiscal and macroeconomic imbalances. In recent years, good progress has been made in developing a strategy for the sector and addressing these issues. An energy pricing commission was established to function as a regulator of heat, gas, and electricity prices; major measures were taken to commercialize the sector and solve the energy arrears of public authorities; steps were taken to prepare restructuring and privatization plans for electricity and gas; the oil company was partially privatized; and international accounting standards were adopted by the main state-owned energy companies. Efforts at restructuring have been complicated, however by strategic political considerations, including EU accession goals, which have led to steps to close the first unit at the Ignalina Nuclear Power station and to construct transmission lines to link up with Poland, as well as further integration with the West, which led the previous government to seek a Western strategic investor in the oil sector. Lithuania continues to have important supply links to Russia and other CIS countries, increasing the complexity of these efforts.

#### Electricity

The Lithuanian electricity capacity generation system exceeds the needs of the country. In 2000, the operational capacity was more than three times the peak load, and double the historic peak load in 1991. Around 75 percent of the electricity is generated by one of the two nuclear reactors at the Ignalina power plant, and most of the remainder is supplied by thermal and hydroelectric plants under the Lithuania Power Company (LPC), while district heating is run by municipalities. In 2000, residential users accounted for more than one-third of total electricity consumption, followed by transport and industry. Lithuania imports nuclear fuel mainly from Russia, and exports electricity to Belarus, Latvia, and Russia. Belarus has some payments arrears, despite partial clearance via barter arrangements or sale of the debt to third parties. The export strategy targets to maintain old markets and to find new markets in the West. Thus, in February 2001, Lithuania signed an agreement with Belarus, Estonia, Latvia, and Russia for synchronizing national power grids. Lithuania is also working with Poland on a project for the interconnection of the two national electricity grids, with the assistance of the EBRD; the completion of the project is expected by 2003.

*The Lithuanian Power Company or Lietuvos Energija* (LPC), 86.25 percent state-owned, owns and operates the electric transmission and distribution system and all major power plants with the exception of Ignalina. LPC had run big losses in the past, due both to Belarus's failure to pay for exports, and delays in raising tariffs on a timely basis. In the last five years, steps have been taken to improve the financial situation. In 1996, measures were taken to reduce consumer arrears. In 1997, LPC was reorganized and 16 local district heating companies were established, with shares transferred to the municipalities. In 1997, an independent energy pricing commission was established. The last round of tariff increases took place in January 2000, and a further increase is expected in 2001. In May 2000, a law on restructuring LPC into generation, transmission, and distribution companies was passed, with the intention of privatizing the distribution network by the end of 2001. However, due to technical and political reasons some delays for the privatization of the company have arisen, and the approval by parliament of the government's restructuring plan, originally scheduled for January 2001, occurred only in June 2001. The registration of LPC successor companies is expected to be completed by end-2001, and the offer for sale of distribution and generation companies for end-February 2002, with closing of the privatization transactions targeted for end-June 2002. In April 2001, LPC signed an agreement to sell power utility to the Inter RAO UES Russian company for export to Belarus.

*Ignalina Nuclear Power Plant* (INPP) Lithuania is one of the most nuclear-reliant countries in the world. The nuclear power is generated by the INPP, which has two Chernobyl-type reactors (the first began service in 1983 and the second in 1987), whose service life is projected to end in 2010-15. At present, only one unit is in service, and it operates at 40-45 percent capacity. In 1993, the first safety improvement program was initiated. Since then, US\$200 million has been spent in safety improvements and an additional US\$500 million is planned. Moreover, under pressure from the international community, in particular the EU, parliament narrowly adopted the National Energy Strategy in 1999, committing the country to an early closure of the INPP's first unit by 2005. A decision about the closure of the second reactor should be made in 2004, with decommissioning in 2009, but the EU demands a final decision by 2002. The total direct and indirect costs of the closure of INPP are currently estimated at US\$3.5 billion, spread over 70 years. The direct costs associated with the closure of the first reactor are estimated at US\$178 million over five years. This amount was pledged by the EU and other donors in June 2000, and a closure fund has been established under the management of the EBRD. Financial assistance would also be needed to shoulder the costs of closing the second reactor.

## Oil

Lithuania has small offshore oil reserves in the Baltic Sea, which have been explored by the Lithuanian firm Geonafta and Scandinavian companies, but Russia remains the main supplier of crude oil. The oil sector, which includes an oil refinery, a pipeline, and a new oil terminal at Butinge, was restructured in 1998 as the Mazeikiu Nafta (MN) public company. Before privatization, the company experienced increasing financial difficulties stemming from poor management, overcapacity in the Butinge terminal, and crude oil supply shortages. In October 1999, MN was partially privatized, with 33 percent of the company's equity sold to Williams International for US\$75 million, which was reinvested in the company, after nearly two years of direct negotiations and public controversy over the terms of the deal, leading to the Prime Minister's resignation. The government provided US\$324 million in long-term financing and US\$75 million in loan guarantees to the company. Moreover, the government pledged additional guarantees of US\$118 million to finance a US\$700 million prospective investment program. The refinery requires substantial modernization and investment to produce products suitable for the Western European markets and broaden its sales base. In 2000, MN experienced disruptions in oil supplies from Russia, its main supplier, forcing the refinery to work substantially under capacity. In June 2001, MN was able to secure long-term crude oil supplies from the Russian company Yukos. A key prerequisite for MN to arrange financing for the company's modernization plans is secure long-term supplies. The government approved the general terms of the agreement with Yukos, and it is currently analyzing the details.

## Gas

Lithuania's natural gas transmission and distribution network is operated by Lithuanian Gas (LG), which is 92.4 percent owned by the government. The main supplier of natural gas is Russia. The transmission network is connected to Latvia, Belarus, and the Kaliningrad region of Russia. As in the case of the LPC, the financial situation of the company was affected by tariffs kept below production costs, but the situation improved after tariff increases in January 2000. LG is currently being restructured and is set to be privatized in the second half of 2001.

## Outstanding issues

Considerable progress has been achieved in commercializing the energy sector, strengthening operations, and creating appropriate regulatory institutions, but a number of important issues remain to be solved. First, a strategic western investor has so far entered only the oil sector, and the agreement with Yukos represents a first step in securing supplies. However, there is an urgent need to proceed with the modernization of the refinery, but this will be costly and risky. If it is not done properly, it will entail considerable financial risks to the government. Second, in gas and electricity, strong political commitment will be needed to complete in 2001-02 the privatization of gas and electricity distribution and generation, which could bring major foreign investors. A decision on how to split tariffs of generation, transmission, and distribution of electricity also needs to be made. In addition, the Belarusian debt problem needs to be solved, and new arrangements for exports to Belarus have to be closely monitored to ensure that no new arrears are incurred. Third, in order to complete EU accession negotiations in 2002, a decision must be taken next year regarding the closure of the INPP, with important implications for production and exports in the long run. Energy alternatives exist, but they could be very costly and adversely affect energy prices. The country could import from Russia and Western European countries, in which case new infrastructure and grid interconnections should be put in place. Lithuania could retain self-sufficiency by utilizing the full capacity of its existing, but largely idle and obsolete, hydroelectric and thermal power stations, but that would require important new investments. The country could build a new nuclear unit in accordance with western standards; it would be a very costly solution in the short run, but with lesser effects on electricity prices than under other options in the long run.

Table. Lithuania: Importance of the Energy Sector in GDP, 1997-99

	1997	1998	1999
<b>Share of Value Added in Total Industry</b>			
Electricity, gas, steam and hot water supply	14.4	17.0	16.3
Refined oil	7.2	6.2	4.8
<b>As percentage of GDP</b>			
Electricity, gas, steam and hot water supply	3.6	4.1	3.8
Refined Oil	1.8	1.5	1.1

Source: Lithuanian authorities.



### III. THE PROGRAM FOR JULY 2001-DECEMBER 2002

#### A. Objectives and Policies

15. **The new program aims at maintaining macroeconomic stability, strengthening external viability, and facilitating private activity.** These efforts would help prepare Lithuania for an early accession to the EU and, over the medium term, to attain higher and more sustainable growth, greater employment opportunities, and increased welfare for the Lithuanian population.

16. **The program is based on a strategy of maintaining the currency board arrangement, and continuing the fiscal consolidation effort, together with advancing the remaining key structural reforms.** The authorities announced that there will be a switch of the anchor currency under the currency board arrangement (CBA) from the dollar to the euro on February 2, 2002. The fiscal consolidation will target a budget deficit reduction path to support the CBA and maintain external viability, with the aim of reaching a balanced budget by the time of EU accession. Fiscal policy will need to balance plans for rationalizing the tax structure with new expenditure obligations, financing of pension reforms, stabilization of municipal finances, and expenditure restructuring in health and education. Structural reform efforts will focus on addressing remaining fiscal structural weaknesses, continuing financial sector reform, improving the business environment, enhancing labor market flexibility, and completing the privatization program.

#### B. Macroeconomic Outlook

17. **After the large fiscal and external adjustments in 2000, macroeconomic policies in 2001-02 aim at maintaining low inflation, and keeping the external current deficit at a sustainable level, supporting the economic recovery** (Tables 1-3). Real GDP is expected to grow by 3.6 percent in 2001 and 4.7 percent in 2002, reflecting a recovery of domestic demand and continued good export performance. Private consumption and private investment are projected to increase from 64.3 percent of GDP and 18.7 percent in 2000, respectively, to 65.3 and 20.1 percent in 2001, respectively, and further in 2002 to 65.8 and 20.3 percent, respectively. The pick-up of domestic demand in 2001 would lead to an increase in imports and a slight widening of the external current account deficit in 2001 (to 6.7 percent of GDP). Subsequently, the current account deficit would start to slightly decline again in 2002, due to sustained export growth, a more business-oriented regulatory environment, and a deepening in structural reforms. The targeted fiscal adjustment will help contain domestic demand, thereby underpinning the projected current account deficit path. Foreign direct investment (FDI) is projected to increase significantly in 2001-02, as several major privatization projects are to be completed during this period. Access to capital markets on favorable terms is expected to continue, and external debt ratios would remain moderate and stable.

Selected Macroeconomic Indicators, 1999-2005

	1999	2000	2001	2002	2003	2004	2005
					Proj.		
Real GDP growth (y-on-y in percent)	-3.9	3.3	3.6	4.7	5.2	5.6	6.0
Fiscal balance (in percent of GDP)	-8.5	-2.8	-1.4	-1.3	-1.7	-0.9	-0.8
Current account balance (in percent of GDP)	-11.2	-6.0	-6.7	-6.6	-6.4	-5.8	-5.7
End-of period CPI inflation	0.3	1.5	2.0	3.0	3.0	3.0	3.0

18. **The projected economic growth path of 5-6 percent annually for the period 2003-05** (Tables 3-5, and Appendix V) would be underpinned by determined implementation of structural reforms which, together with a possible early accession to the EU, would make Lithuania more attractive for foreign investors and boost confidence in the economy further, thus leading to continued export growth and a further stimulation of domestic demand. The external current account would remain broadly unchanged at around 6 percent of GDP by 2005, supported by the maintenance of fiscal discipline, as well as further improvement in Lithuania's competitiveness brought about by structural reforms. The projected current account deficit path, while showing a small adjustment in 2001-05, is consistent with a further strengthening of external viability as reflected in a decline of debt ratios. This decline would result from a combination of rapid economic growth and moderate increases in nominal debt, attributable to a large share of FDI in external financing and access to foreign financing at low spreads. Inflation would remain at 2-3 percent. National saving would increase from about 15 percent of GDP in 2000 to more than 17 percent in 2005, owing to further fiscal consolidation, and an increase in private saving, in response to pension reform and availability of a wider array of saving instruments with further progress in the sophistication of the banking system and capital markets.

### C. Exchange Rate and Monetary Policies

19. **The currency board will continue to anchor macroeconomic policies, providing a stable monetary framework, helping to keep inflation low and bolstering confidence.** The public announcement of the repegging, made seven months in advance, should give adequate time to the private sector to minimize their risk exposure to changes in the dollar/litas exchange rate after the switch. Moreover, given the history of currency changes leading to an erosion of savings, the BoL considers that the transparency of their plans for the switch should help maintain confidence in the CBA. In the coming months, the BoL will take preparatory steps for the repegging, according to a carefully laid out timeline, and conduct a comprehensive public relations campaign to keep the population fully informed of the process and minimize uncertainties.

20. **Continued monetization is expected during the program period, given the strong confidence in the CBA** (Table 4). In 2001, broad money is projected to grow at about 8.9 percent, with some further decline in velocity. Credit to the private sector is envisaged to grow by 9.5 percent, as business opportunities increase, and the banking sector becomes more competitive in the wake of privatization. No reductions are envisaged in the required reserve ratios at this time, since the banking system appears sufficiently liquid and loan/deposit interest spreads are falling.

21. **Following the shift of the Treasury accounts from commercial banks to the central bank**, greater coordination between the BoL and the Treasury to minimize liquidity fluctuations in the banking system is required. Given the ample liquidity, the system was able to handle the once-and-for-all liquidity contraction. In addition, the BoL intends to create appropriate conditions for enabling banks to cope with liquidity fluctuations associated with Treasury operations. The BoL will examine the efficiency of both the interbank market and foreign exchange markets and consider measures to improve their functioning, such as streamlining and standardizing the current cumbersome collateral requirements in the interbank market, and reducing transaction fees imposed by the BoL in its dealings with commercial banks in the foreign exchange market. At this juncture, the BoL plans to keep interventions in the interbank market at a minimum, consistent with the spirit of the CBA.

#### **D. Fiscal Policy**

22. **The government's medium-term objective of achieving a structural balanced budget by the time of EU accession**, excluding the cost of the pension reform, will help boost the credibility of the CBA, contribute to a reduction in interest rate spreads, and underpin the projected current account deficit adjustment. To carry out the fiscal deficit adjustment and create favorable conditions for sustainable employment-generating growth, there is a need for expenditure restructuring and tax reform. The amount of revenue losses stemming from the tax reform, however, would have to be limited by the need for continued fiscal adjustment and new expenditure commitments, including the cost of EU and NATO accession (MEP, paragraph 11).

23. **The government sees a need for a comprehensive tax reform**, in order to: (i) stimulate employment-generating growth; (ii) make Lithuania's tax system compliant with EU requirements; (iii) provide municipalities with their own sources of revenue to strengthen their revenue base and provide incentives for sound financial management; (iv) align capital taxation with EU practices; and (v) eliminate a number of loopholes from the existing tax system. The new government preliminary proposal on the tax reform for 2002 is in line with the staff recommendations and includes an increase of the tax exempt minimum (TEM), changes to the corporate income tax (CIT), and alignment of consumption taxes with EU requirements (MEP, paragraph 10). The new government is working on the details of the tax reform. As regards the medium term, it is important that the reform be consistent with medium-term fiscal viability and expenditure commitments (a possible package of tax measures recommended by the staff is presented in Appendix V).

24. **The fiscal deficit for 2001 of 1.4 percent of GDP remains appropriate** (Table 2). The revised national budget approved by Seimas in July increased both revenue and expenditure targets by LTL 80.3 million (0.2 percent of GDP), while keeping the budget deficit target unchanged. The national budget revenue target has been revised mainly on account of already realized higher nontax revenue. If revenue performance did not meet expectations later in the year, the government is committed to cut back expenditure in order to meet the budget deficit target. Moreover, the operations of the HIF will be rationalized as described in the MEP (paragraph 16). The authorities intend to resist strong pressures for additional expenditure, making sure that all expenditure commitments are reflected in the budget, and redoubling their efforts to collect debt payments from

their debtors. Thus, the program targets include ceilings on domestic and foreign debt guarantees to limit the government's exposure to contingent liabilities. In this regard, the government might be obliged to provide further guarantees for the investment by the Mazeikiu Nafta Oil Company as stipulated by the privatization agreement (Box 3). In light of recent developments regarding long-term oil supplies, this obligation appears less needed and the government will make its best effort to refrain from providing these guarantees.

25. **The fiscal deficit target for 2002 of 1.3 percent of GDP reflects a balance between a number of considerations.** On the one hand, the commitment to continue fiscal adjustment is particularly important in the run-up to the repegging to boost credibility of the CBA. On the other hand, after the sharp adjustment in 2000-01, the deficit reduction in 2002 could only be gradual, given the short-run costs of the first stage of the tax reform, increased expenditure related to EU accession, education, defense and environmental commitments, and the need to maintain an adequate level of essential government functions.

26. **General government revenue is likely to decline in 2002 by 1.5 percent of GDP,** with one percentage point attributable to slow growth of non-tax revenue and the payroll and PIT tax base and 0.5 percent attributable to the government's plans to: (i) increase the TEM of the PIT from LTL 214 to LTL 250; (ii) reduce the CIT from 24 to 23 percent and introduce accelerated depreciation in some cases, while eliminating most exemptions and tax breaks; and (iii) realign consumption taxes with a view to bringing them in line with EU requirements (MEP, paragraph 13). Since the tax reform measures need to be approved by Seimas, the final package could be somewhat different. In that case, the government will propose additional revenue or expenditure measures to reach the targeted fiscal deficit.

27. **Although expenditure will remain constant in real terms, the estimated revenue losses relative to GDP will necessitate some expenditure cuts and reallocation.** The bulk of expenditure adjustments will fall on the state budget. The state budget will have to compensate municipalities and the HIF for the loss of some PIT revenues (0.2 and 0.1 percent of GDP, respectively). In addition, the operations of the road program will have to be streamlined due to the projected loss of revenue on account of the phaseout of the gross turnover tax. Finally, the state budget will have to cut expenditure by an additional 0.5 percent of GDP to offset losses from the nontax revenue and the implementation of warehousing procedures for excises. Despite a further projected decline of the payroll tax relative to GDP, the deficit of SoDra is projected to decline on account of slow expenditure growth under the current benefit structure.

28. **Financing needs in 2002 should be met comfortably,** given a substantial lengthening of maturities and deepening of the domestic market for government securities and access to international capital markets on favorable terms. The government plans to tap international capital markets in 2002, to refinance \$200 million of the maturing 1997 eurobond. Hence, there is a need to maintain credibility to preserve favorable access.

## E. Structural Reforms

### Fiscal Sector Reforms

29. **The authorities intend to address the structural causes of municipal expenditure arrears.** First, draft amendments on the Law on the Methodology of Establishment of Revenues of Municipal Budgets will seek to determine better municipal functions and the funding of state-mandated obligations. Second, the government plans to prepare a comprehensive set of measures in order to overhaul municipal finances by the time of the completion of the first review. Such measures would have to identify new sources of revenue and link any bailout by the state to the implementation of arrears clearance plans. In this connection, the State Auditor will be asked to conduct a performance audit of some municipalities, estimate the amount of arrears related to unfunded obligations, and recommend solutions.
30. **The government plans to implement measures to eliminate the existing stock of municipal arrears.** First, a Cabinet level commission will monitor the arrears situation on a monthly basis. Second, additional financial transfers to municipalities to help clear expenditure arrears will be conditional on the actual progress in arrears clearance (MEP, paragraph 15). The staff underscored that the government will have to refrain from any unconditional bail-outs of municipalities to eliminate the problem of moral hazard.
31. **The government will prepare legislation for the upcoming pension reform, introducing a three-pillar pension system (MEP, paragraph 17).** As soon as Seimas has passed the reform of the pension system, the government will submit to Seimas a draft amendment to the current Law on Social Security to allow funds to be channeled to the second pillar, and a draft law authorizing private pension funds to manage the accumulated resources under the second pillar. In addition, by end-September the government will submit to Seimas a draft amendment to the law on privatization to institute the Reserve Stabilization Fund (RSF) and by end-November the government will approve the regulations for the RSF in line with the July 2000 Fiscal Affairs Department TA mission recommendations (MEP, paragraph 17). Finally, the government will maintain the improved financial position of SoDra and take steps to reduce eligibility for state pensions paid directly by the state budget.
32. **The government will further strengthen tax administration and improve administrative capacity and fiscal transparency.** The government will resubmit to Seimas a new draft Law on merging the SoDra's payroll tax collection unit with the STL. Moreover, EU grants and the needed cofinancing will be included in the 2002 draft budget. Furthermore, control over appropriation managers will be strengthened through monthly monitoring with a view to establishing better expenditure controls and avoid the accumulation of the central government arrears. Finally, the government intends to request a Report on Observance of Standards and Codes (ROSC) to review its current practices and define ways of improving fiscal transparency (MEP, paragraph 19).

## Financial Sector Reforms

33. **The authorities will take additional steps to strengthen the banking system, and reduce government involvement further**, including by privatizing the Agricultural Bank (MEP, paragraph 25). To complete the legal framework for financial markets, the government will prepare regulations for the implementation of several financial sector laws and amendments to laws recently passed by Seimas. The latter include the amendment to the Commercial Banking law to speed up liquidation of banks undergoing bankruptcy, the amendment to the Pension Fund law to liberalize conditions for the establishment of the voluntary third pillar, and the Insurance law, which establishes similar requirements for foreign and local entities in line with EU regulations. In addition, the authorities have recently submitted to Seimas the amendment to the Securities Insurance law to increase investor protection, and the General Financial Institutions law. The government will follow closely the recommendations of the Financial Sector Assessment (FSAP) mission scheduled for the second half of this year, to assess the legal framework and to improve banking supervision and financial sector efficiency.

## Other Reforms

34. **Further progress in structural reforms and improving the business climate are key to ensuring an environment conducive to private activity and attracting FDI.** Important measures are being undertaken by the authorities in these areas, (MEP, paragraphs 20 and 23), notably continuing privatization of small and large public enterprises, including Lithuanian Airlines; steps to facilitate and enhance business activity, including cutting red tape and facilitating the functioning of currently well-performing enterprises through the revision of procedures for tax arrears write-offs and deferrals accumulated during the Russian crisis (MEP, paragraph 18); and simplification of the restitution of land ownership rights. In addition, despite difficulties and delays in the last months, the government remains committed to make every effort to enhance the efficiency in the energy sector, through the restructuring of the LPC and subsequently the privatization of distribution and generation companies, and the privatization of the Lithuanian Gas Company (MEP, paragraph 24). In all its privatization efforts, the government remains committed to ensuring a transparent process.

35. **To reduce unemployment in the medium term, the government will continue to foster labor market flexibility** through measures such as short-term contracts and eliminating mandatory minimum number of working hours. To help the unemployed find jobs, the government will continue to finance well-targeted job training programs geared to meet private sector needs. In addition, to codify the existing regulations, a draft Unemployment Insurance law and Labor Code will be submitted to Seimas (MEP, paragraph 22). Since the high unemployment rate is largely of a structural nature,<sup>6</sup> related to skill mismatches and limited geographical mobility, its reduction is likely to be only gradual, and the government will seek to improve and target better the existing social safety nets (unemployment benefits, family benefits and social benefits for low-income families), in order to help the long-term unemployed maintain a minimum standard of living.

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<sup>6</sup> IMF Country Report No. 01/19, Box 1.

36. **As regards agriculture, further progress is needed to restructure the state food market regulatory agency**, which has suffered losses on grain procurement, storage and export operations, limiting the availability of funds for projects that could receive EU SAPARD cofinancing. Priorities for rural development projects include employment diversification and extension of infrastructure (communications, utilities, roads and water supply). The lack of constitutional amendments providing for land ownership by domestic legal entities—including banks—continues to limit development of land and credit markets.

37. **Lithuania has made rapid progress in its EU accession negotiations which were initiated in 2000.** The authorities are aiming to close all chapters of the EU *Acquis Communautaire* by end-2002, hoping to join the EU in the first enlargement wave in 2004. The pace of negotiations has accelerated in recent months: 18 of the 29 negotiation chapters plus two appendixes have been closed; additional chapters could be closed by end-2001. However, the EU Commission recently expressed its concern over delays in the energy sector restructuring and insufficient progress in the distribution of EU funds, warning that these issues, if not addressed promptly, might affect the chance of joining the EU in the first wave.

38. **Lithuania's statistics are generally adequate for conducting effective surveillance and macroeconomic analysis.** The authorities have subscribed to the SDDS since May 1996. While some weaknesses in national accounts and balance of payments statistics remain, improvements are being made with technical assistance from various organizations including the Fund. As compilation standards strengthen, some data series may be subject to later revisions. The improvement to the compilation of government finance statistics remains a priority under the program.

#### **IV. PROGRAM MONITORING, ACCESS UNDER THE SBA, AND CAPACITY TO REPAY THE FUND**

39. **Program implementation will be monitored through a set of quarterly quantitative performance criteria and indicative benchmarks (MEP, Tables 1 and 2), and a set of structural benchmarks (MEP, Table 3).** These performance criteria and benchmarks were selected on the basis of their relevance for achieving the program's objectives of maintaining macroeconomic stability and accelerating key structural reforms. The first program review, expected to coincide with the 2001 Article IV consultation discussion and to be concluded by end-December 2001, will be based on the end-September 2001 outcomes. At that time, performance criteria and possible additional structural benchmarks for end-March and end-June 2002 will be established. Performance criteria for end-September and end-December 2002 and possible additional structural benchmarks will be specified at the time of the second program review, which will be based on the end-March 2002 outcomes and is scheduled to be completed by June 2002. The last program review will be based on the end-September 2002 outcomes and is expected to coincide with the 2002 Article IV consultation discussion and to be concluded by end-December 2002.

40. **Under the program, the proposed access of SDR 86.52 million (60 percent of quota) for a 19-month SBA would contribute to enhance market confidence in the run-up to the repegging. Seven equal purchases of amounts equivalent to SDR 12.36 million would be available, the first one upon Board approval, and then six quarterly purchases (Table 6).** The

authorities do not intend to draw and would treat the arrangement as precautionary, as was the case with the previous one, unless a financing need were to emerge in the event of adverse external shocks.

41. In view of Lithuania's good track record in servicing its obligations to the Fund, it is expected that all future payments will be made according to schedule. The current debt owed to the Fund is only 3 percent of total debt. In the event the authorities chose to make all available purchases, Lithuania's debt service to the Fund would peak in 2005, but would only account for slightly over one percent of exports (Table 7).

42. The authorities have submitted to the Fund the necessary documentation for the safeguards assessment, which is currently under review.

#### V. STAFF APPRAISAL

43. **Lithuania made remarkable progress under the program supported by the previous stand-by arrangement.** As a result of the authorities' efforts, the budget and external current account deficits declined sharply; real GDP growth resumed; inflation remained subdued; structural reforms advanced, and confidence in Lithuania's policy making was restored, allowing for continued access to domestic and international capital markets at declining spreads. Significant progress was also registered on EU accession negotiations. In spite of this progress, some areas of weakness remain. Unemployment is still high, and social safety nets need to be reinforced. Moreover, the finances of municipalities and the HIF should be strengthened and administrative capacity of public institutions should be improved. Further improvements to the business environment and greater labor market flexibility are needed, in order to promote higher rates of growth, domestic and foreign investment, output, and employment creation. Insufficient progress was made in restructuring the energy and agricultural sectors.

44. **The new program aims to build on the successes of the previous program, while addressing the unfinished reform agenda.** Preserving macroeconomic stability will bolster credibility in the run-up to the repegging of the litas, and an acceleration of structural reforms will help promote private activity, leading to higher growth and employment creation. Such an acceleration is crucial if Lithuania wants to conclude accession negotiations with the EU in 2002, and to join in the first wave of enlargement. Although Lithuania's external vulnerability has been reduced, the staff cautions against policy slippages or a loss of the reform momentum, which could lead to a rapid change in market perceptions.

45. **The cornerstone of the authorities' strategy continues to be fiscal restraint, after the substantial fiscal consolidation achieved so far in 2000-01.** A further sizable reduction in the overall deficit of the general government is targeted for 2001. The prospect for an accelerated recovery in 2001 is expected to result in a somewhat more favorable revenue performance, thus helping the authorities to achieve their ambitious targets. The staff welcomes the authorities' commitment to achieve the deficit target and to take any needed additional measures later in the year to this end.



46. **In the staff's view, the 2002 budget target achieves a good balance** between the need to maintain a prudent fiscal stance in advance of the repegging of the litas, contributing to enhance confidence in economic policies, and to leave room for financing new expenditure demands, including the potential costs of EU and NATO accession. On the expenditure side, as there may be little room for further cuts if essential services and social expenditures are to remain adequate, the staff urges the authorities to pursue expenditure rationalization and to improve the effectiveness of public administration.

47. **The fiscal stance should be assessed in a medium-term context.** The staff welcomes the authorities' approach of preparing a medium-term fiscal framework, determining priorities and seeking ways to achieve the medium-term goal of a balanced budget. The staff supports the authorities' objective of simplifying and making the tax system more transparent, bringing it in line with the EU, but considers there is limited scope for measures that would entail large and immediate revenue losses. A gradual phasing of tax reforms over several years would alleviate the tax burden and promote economic growth, while remaining consistent with the expenditure and fiscal balance objectives. In this connection, the staff welcomes the government's decision to reduce slightly the CIT in 2002, while easing somewhat the tax burden on labor by increasing the tax exempt minimum for the PIT. Finally, ensuring an effective use of EU cofinancing to support public investment will be key for the achievement of medium-term fiscal objectives.

48. **The authorities should continue to implement fiscal reforms.** Despite significant progress in improving budget transparency and tax administration, as well as major measures leading to the improvement of the financial position of SoDra, the growth of municipal arrears and the persistence of a small amount of arrears of the central government are worrisome. Prompt corrective actions in this area are required. In this regard, the staff urges the authorities to proceed with the reform of municipal finance, which may take time if the structural causes of the arrears problem are to be effectively addressed, while refraining in the meantime from unconditional bailout or offset operations. Expenditure control and budget management should also be strengthened to eliminate arrears at the central government level. Other important areas of reform are the finances of the HIF and the Road Fund. The staff welcomes the progress in preparing for the pension system reform, to be implemented as of 2003, and supports the authorities' view that it should be financed by privatization proceeds at the early stage, through the newly established RSF. In view of financial constraints, the staff supports the authorities' commitment to limit cash outlays for the savings and land restitution programs during the program period, and devote more resources to finance future costs of the pension reform and debt repayments.

49. **The staff endorses the authorities' intention to switch the peg of the litas to the euro,** with a view to moving smoothly toward greater economic integration with the EU area, while preserving the credibility of the currency board. The staff shares the authorities' view that the currency board has constituted a linchpin of stability for macroeconomic policies, providing an incentive to adjustment and an effective defense against spending pressures and populist programs. The staff supports the authorities' plans to make the repegging process as transparent as possible, and urges the authorities to continue policies that minimize uncertainty and buttress credibility. The authorities are mindful of the risk of a relatively weak euro at the time of the switch. In such

circumstances, for the economy to adjust to the new peg without undue output losses, further structural reforms and productivity growth are needed to speed up real convergence with the EU through real appreciation rather than domestic inflation. For the future, the viability of the currency board will hinge on continued fiscal restraint and a strengthening of external competitiveness.

50. **Regarding the shift of the Treasury accounts from the commercial banks to the BoL,** the staff would like to underscore the importance of ongoing efforts to improve forecasts and coordination of Treasury flows, as well as the functioning of the interbank and foreign exchange markets, so as to prevent excessive volatility of liquidity, especially in the context of the CBA.

51. **While macroeconomic performance was better than expected, progress in structural reforms remained mixed.** On the one hand, important measures were passed by Seimas in order to promote labor market flexibility and facilitate enterprise restructuring. In this regard, the authorities are encouraged to continue to implement the recommendations of the sunrise and sunset commissions and make further steps in deregulating the business environment so as to promote investment and employment over the medium term. In addition, improvements in the business and regulatory environment should be underpinned by an effective implementation at the administrative level. Privatizations of the Savings Bank and LISCO were successfully concluded. In this regard, the staff welcomes the authorities' determination to conduct the privatization process transparently, without preferential treatment to individual investors, which is critical for governance and to gain public support for these policies. On the other hand, progress in energy sector reforms and agriculture was disappointing, leading to delays in the disbursements of the second tranche of the World Bank SAL. Thus, looking ahead, the staff urges the authorities to implement structural reforms in these areas more decisively in the coming months. Further delays in the restructuring of LPC and the privatization of Lithuanian Gas as well as in the reform of the agricultural sector could jeopardize Lithuania's ambitious timetable for EU accession. In addition, reform of the state food market regulatory agency is needed.

52. **The program targets are achievable but, nonetheless, the authorities' strategy has risks.** First, in the context of the currency board, the strategy hinges crucially on stringent fiscal discipline, with little room for slippages. For the fiscal targets to be met, the government will need to resist pressures to increase spending or to provide support or tax benefits to certain sectors, while proceeding cautiously with tax reforms so as to avoid unaffordable revenue losses. Second, passage of a very large number of key legislative proposals by Seimas—in particular those pertaining to energy privatization and tax reforms—is essential to enable reforms to proceed during 2001-02. The government needs to persevere with some difficult reforms in these areas, and to obtain necessary support in Seimas. Third, adverse external developments may also pose additional challenges for economic policy-making, creating additional uncertainties in the run-up to the repegging. A slowdown in partner countries' growth may exert a negative impact on Lithuania's ongoing recovery. A further sharp appreciation of the dollar could have an adverse effect on competitiveness and growth. Moreover, pressures in international financial markets might limit the government's access to foreign financing on favorable terms, driving up debt servicing costs. In that event, the government would have to stand ready to tighten the policy stance, while continuing structural reforms to promote competitiveness and employment-creating growth.

53. **Nonetheless, the staff considers that the authorities' program is strong.** The swift endorsement by the new government of the MEP and the package of reform measures, as well as its determination to adhere to ambitious fiscal deficit targets, harnessing broad-based parliamentary support for the goal of EU accession, are reassuring. Overall, macroeconomic conditions are improving and the policy stance remains appropriate. The staff is confident that the authorities stand ready to modify policies promptly and appropriately in response to adverse external or domestic shocks. The staff also trusts that the authorities will make their best efforts to speed up the implementation of their structural reform and privatization programs. Thus, the staff would recommend the approval by the Board of the new stand-by arrangement.

Table 1. Lithuania: Selected Macroeconomic Indicators, 1998-2002

	1998	1999	2000	2001		2002
			Prel.	Prev. Proj.	Prog.	Proj.
<b>National income, prices, and wages</b>						
Nominal GDP (in millions of litai) 1/	42,990	42,655	44,930	47,400	47,012	50,509
GDP (in millions of U.S. dollars) 1/	10,748	10,664	11,232	11,850	11,753	12,627
Real GDP growth (year-on-year, in percent) 1/	5.1	-3.9	3.3	3.6	3.6	4.7
Average CPI (year-on-year change, in percent)	5.1	0.8	1.0	1.0	0.6	2.8
End-of-period CPI (year-on-year, in percent)	2.4	0.3	1.5	1.9	2.0	3.0
GDP deflator (year-on-year, in percent)	6.7	3.2	2.0	2.1	1.0	2.6
Average monthly wage (in U.S. dollars)	232	247	252	...	...	...
Unemployment rate (in percent) 2/	6.9	10.0	11.5	...	...	...
<b>Saving-investment balance (in percent of GDP)</b>						
Gross national saving	12.3	11.5	14.7	14.9	15.2	15.4
General government	-0.7	-4.0	-0.4	0.5	0.7	0.8
Non-government	13.0	15.4	15.1	14.5	14.6	14.6
Gross national investment	24.4	22.7	20.7	21.4	21.9	22.0
Foreign saving	12.1	11.2	6.0	6.5	6.7	6.6
<b>General government (in percent of GDP)</b>						
Financial balance	-4.4	-6.2	-2.1	-1.3	-1.3	-0.9
Net lending	1.5	2.4	0.7	0.1	0.1	0.4
Fiscal balance	-5.9	-8.5	-2.8	-1.4	-1.4	-1.3
<b>External sector</b>						
Current account balance						
in percent of GDP	-12.1	-11.2	-6.0	-6.5	-6.7	-6.6
in millions of U.S. dollars	-1,298	-1,194	-675	-771	-786	-836
Gross official reserves (in millions of U.S. dollars) 3/	1,460	1,242	1,359	1,668	1,790	1,986
External debt (in percent of GDP) 4/	34.8	42.5	43.2	43.2	44.8	44.5
Debt service (in percent of exports of GNFS)	18.3	20.0	20.9	13.3	13.5	16.4
Exchange rate (litai/euro, period average)	...	4.2	3.7	...	...	...
Real effective exchange rate (1995=100, "+"=appreciation) 5/	142	160	171	...	...	...
<b>Money and credit</b>						
Reserve money (year-on-year change, in percent)	28.8	-4.0	-3.0	0.2	2.0	4.4
Broad money (year-on-year change, in percent)	14.5	7.7	16.5	6.9	8.9	8.5
Private sector credit (year-on-year change, in percent) 6/	16.9	13.8	-1.2	11.3	9.5	9.8
Money multiplier	2.0	2.2	2.6	2.8	2.8	2.9
Currency/deposits, in percent	50.7	43.9	34.1	32.5	32.5	31.6
Foreign currency deposits/ litai deposits, in percent	57.0	77.7	83.8	80.9	80.9	80.9

Sources: Lithuanian authorities; and Fund staff estimates and projections.

1/ GDP for 1999 has been substantially revised by the Statistical Office since EBS/00/28 has been published.

2/ Registered unemployment, end-of-period.

3/ Gross official reserves reported here differ from the monetary survey because they include reverse repos involving major currencies in both legs.

4/ External liabilities minus equity investment in Lithuania.

5/ CPI-based, trade-weighted real exchange rate against 21 major trading partners in 1999.

6/ Dec. 2000 is adjusted for LTL 270 million of DMB's reclassified loans. If included, private sector credit would fall by 6.1 percent.

Table 2. Lithuania: Summary of Consolidated General Government Operations, 1998-2005

	1998	1999	2000		2001			2002	2003	2004	2005
		Prel.	Prel. 1/	Q1	Initial Budget 2/	Prog.	Q1		Proj.		
(In millions of litai)											
Revenue and grants	14,036	13,687	13,688	3,118	14,525	14,546	3,434	14,775	15,551	18,439	19,792
Grants	0	0	0	0	0	0	0	0	0	1,685	1,741
Revenue	14,036	13,687	13,688	3,118	14,525	14,546	3,434	14,775	15,551	16,754	18,050
Tax revenue	13,433	12,955	12,845	2,904	13,553	13,489	3,011	13,756	14,455	15,598	16,832
Taxes on income and profits	4,017	3,971	3,836	858	4,009	4,000	843	4,000	3,838	4,176	4,459
Payroll tax (social security tax) 3/	3,063	2,891	3,194	752	3,333	3,290	782	3,445	3,283	3,576	3,948
Taxes on goods and services	5,596	5,385	5,157	1,140	5,582	5,583	1,212	5,555	6,009	6,471	6,893
Other tax revenue	756	709	657	154	630	615	174	757	1,325	1,374	1,532
Non tax Revenue	603	732	844	214	972	1,057	423	1,019	1,096	1,156	1,218
Expenditure and net lending	16,362	17,152	15,011	3,642	15,204	15,160	3,467	15,433	16,477	19,000	20,337
Expenditure	15,734	16,146	14,711	3,531	15,141	15,097	3,485	15,246	16,477	19,000	20,337
Current expenditure	14,326	15,190	13,839	3,367	14,311	14,235	3,410	14,389	15,368	17,480	18,478
Wages and salaries, excl. contributions to SoDra 4/	3,290	3,513	3,450	774	3,498	3,499	782	3,535	3,718	3,959	4,215
Goods and services	4,899	4,425	4,088	980	4,341	4,258	930	4,274	4,672	5,238	5,453
Transfers to EU	0	0	0	0	0	0	0	0	0	673	733
Transfers to households	4,977	5,244	5,401	1,333	5,502	5,475	1,416	5,602	5,870	6,207	6,653
Subsidies	202	150	103	48	100	82	12	84	86	426	440
Interest payments 5/	507	650	782	232	845	902	268	870	997	952	959
Savings restitution program	450	1,207	15	0	25	20	2	25	25	25	25
Capital expenditure	1,408	956	872	164	830	862	74	857	1,109	1,521	1,859
Discrepancy	190	170	-78	-57	0	64	64	0	0	0	0
Financial balance	-1,888	-2,629	-944	-356	-616	-616	-115	-471	-926	-561	-545
Net lending 5/	628	1,006	300	111	63	63	-18	187	0	0	0
Lending	1,017	1,381	529	175	353	353	55	379	300	300	300
of which: Mazeikiai Oil Company	240	800	88	88	0	0	0	0	0	0	0
Repayments	389	-375	-230	-63	-290	-290	-73	-192	-300	-300	-300
Fiscal balance (deficit (-))	-2,516	-3,635	-1,244	-467	-679	-679	-97	-658	-926	-561	-545
Fiscal balance, excluding the cost of pension reform	-2,516	-3,635	-1,244	-467	-679	-679	-97	-658	-379	39	110
Financing	2,516	3,635	1,244	467	679	679	97	658	926	561	545
Net domestic	-286	392	-61	-507	-1,089	-982	-164	-192	726	461	520
Bank financing	-666	326	-495	-606	-1,108	-1,094	-189	-292	626	361	420
Monetary Authorities 6/	-635	602	-480	-626	-1,339	-1,711	-51	-585	305	384	447
Commercial Banks	-31	-276	-16	20	231	617	-138	293	321	-23	-27
Non-bank financing	380	66	434	100	19	113	25	100	100	100	100
Net foreign	535	2,762	502	928	467	371	173	150	0	0	0
Privatization proceeds	2,267	481	803	46	1,300	1,289	89	700	200	100	25

Table 2. Lithuania: Summary of Consolidated General Government Operations, 1998-2005 (concluded)

	1998	1999 Prel.	2000		2001			2002	2003 Proj.	2004	2005
			Prel. 1/	Q1	Initial Budget 2/	Prog.	Q1				
(In percent of GDP)											
Revenue and grants	32.7	32.1	30.5	30.9	30.8	30.9	32.1	29.3	28.4	30.7	30.2
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2.8	2.7
Revenue	32.7	32.1	30.5	30.9	30.8	30.9	32.1	29.3	28.4	27.9	27.6
Tax revenue	31.2	30.4	28.6	28.7	28.8	28.7	28.2	27.2	26.4	26.0	25.7
Taxes on income and profits	9.3	9.3	8.5	8.5	8.5	8.5	7.9	7.9	7.0	7.0	6.8
Payroll tax (social security tax) 3/	7.1	6.8	7.1	7.4	7.1	7.0	7.3	6.8	6.0	6.0	6.0
Taxes on goods and services	13.0	12.6	11.5	11.3	11.8	11.9	11.3	11.0	11.0	10.8	10.5
Other tax revenue	1.8	1.7	1.5	1.5	1.3	1.3	1.6	1.5	2.4	2.3	2.3
Non tax Revenue	1.4	1.7	1.9	2.1	2.1	2.2	4.0	2.0	2.0	1.9	1.9
Expenditure and net lending	38.1	40.2	33.4	36.1	32.3	32.2	32.5	30.6	30.1	31.7	31.1
Expenditure	36.6	37.9	32.7	34.9	32.1	32.1	32.6	30.2	30.1	31.7	31.1
Current expenditure	33.3	35.6	30.8	33.3	30.4	30.3	31.9	28.5	28.0	29.1	28.2
Wages and salaries, excl. contributions to SoDra 4/	7.7	8.2	7.7	7.7	7.4	7.4	7.3	7.0	6.8	6.6	6.4
Goods and services	11.4	10.4	9.1	9.7	9.2	9.1	8.7	8.5	8.5	8.7	8.3
Transfers to EU	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.1	1.1
Transfers to households	11.6	12.3	12.0	13.2	11.7	11.6	13.3	11.1	10.7	10.4	10.2
Subsidies	0.5	0.4	0.2	0.5	0.2	0.2	0.1	0.2	0.2	0.7	0.7
Interest payments 5/	1.2	1.5	1.7	2.3	1.8	1.9	2.5	1.7	1.8	1.6	1.5
Savings restitution program	1.0	2.8	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure	3.3	2.2	1.9	1.6	1.8	1.8	0.7	1.7	2.0	2.5	2.8
Discrepancy	0.4	0.4	-0.2	-0.6	0.0	0.1	0.6	0.0	0.0	0.0	0.0
Financial balance	-4.4	-6.2	-2.1	-3.5	-1.3	-1.3	-1.1	-0.9	-1.7	-0.9	-0.8
Net lending 5/	1.5	2.4	0.7	1.1	0.1	0.1	-0.2	0.4	0.0	0.0	0.0
Lending	2.4	3.2	1.2	1.7	0.7	0.8	0.5	0.8	0.5	0.5	0.5
of which: Mazeikiiai Oil Company	0.6	1.9	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments	0.9	-0.9	-0.5	0.0	-0.6	-0.6	-0.7	-0.4	-0.5	-0.5	-0.5
Fiscal balance (deficit (-))	-5.9	-8.5	-2.8	-4.6	-1.4	-1.4	-0.9	-1.3	-1.7	-0.9	-0.8
Fiscal balance, excluding the cost of pension reform	-5.9	-8.5	-2.8	-4.6	-1.4	-1.4	-0.9	-1.3	-0.7	0.1	0.2
Financing	5.9	8.5	2.8	4.6	1.4	1.4	0.9	1.3	1.7	0.9	0.8
Net domestic	-0.7	0.9	-0.1	-5.0	-2.3	-2.1	-1.5	-0.4	1.3	0.8	0.8
Bank financing	-1.5	0.8	-1.1	-6.0	-2.3	-2.3	-1.8	-0.6	1.1	0.6	0.6
Monetary Authorities 6/	-1.5	1.4	-1.1	-6.2	-2.8	-3.6	-0.5	-1.2	0.6	0.6	0.7
Commercial Banks	-0.1	-0.6	0.0	0.2	0.5	1.3	-1.3	0.6	0.6	0.0	0.0
Non-bank financing	0.9	0.2	1.0	1.0	0.0	0.2	0.2	0.2	0.2	0.2	0.2
Net foreign	1.2	6.5	1.1	9.2	1.0	0.8	1.6	0.3	0.0	0.0	0.0
Privatization proceeds	5.3	1.1	1.8	0.5	2.8	2.7	0.8	1.4	0.4	0.2	0.0
<i>Memorandum Items:</i>											
Public and publicly guaranteed debt, mln. LTL	9,817	12,371	13,028	...	14,036	13,938	...	14,601	14,770	14,647	14,721
In percent of GDP	22.83	29.00	29.00	...	29.78	29.65	...	28.91	26.96	24.42	22.49
GDP, in mln. LTL	42,990	42,655	44,930	10,104	47,135	47,012	10,684	50,509	54,788	59,969	65,447

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

1/ From 2000 onward, 5 new extra-budgetary funds, which had not been reported before, were added.

2/ Fees paid to educational establishments and their spending (LTL 128 million) were added to general government operations from 2001 onward.

3/ Payroll tax contributions outside the general government are reduced by about 0.8 percent of GDP, due to the pension reform from 2003 to 2005.

4/ Including payments by the general government of mandatory pension contributions to the second pillar of about 0.2 percent of GDP from 2003 to 2005.

5/ Interest payments do not include provisioning of defaults, which are reflected under "net lending".

6/ Reflects the operations of the Treasury, Privatization Fund, and prospective Reserve Stabilization Fund. Net withdrawals from the latter contribute to finance the pension reform from 2003 onwards.

Table 3. Lithuania: Balance of Payments, 1998-2005

	1998	1999	2000	2001			2002	2003	2004	2005
				Q1		Year				
				Prel.	Prev. Proj.	Proj.				
(In millions of US dollars, unless otherwise indicated)										
Current account	-1,298	-1,194	-675	-145	-771	-786	-836	-880	-874	-933
Trade balance	-1,518	-1,405	-1,104	-192	-1,116	-1,197	-1,214	-1,268	-1,465	-1,552
Exports (f.o.b.)	3,962	3,147	4,050	1,156	4,448	4,335	4,549	4,877	5,317	5,857
Imports (f.o.b.)	5,480	4,551	5,154	1,348	5,565	5,532	5,763	6,144	6,782	7,409
Non-factor services, net	241	305	380	100	436	400	420	448	472	516
Credits	1,109	1,092	1,059	243	1,137	1,118	1,162	1,230	1,318	1,426
Debits	868	786	679	143	701	719	743	782	847	909
Factor income, net	-255	-258	-194	-105	-297	-246	-311	-359	-405	-452
Current transfers, net	235	163	243	52	207	258	270	299	524	555
Capital and financial account	1,442	1,057	705	239	1,118	1,236	1,072	899	902	947
Capital transfers, net	-2	-3	2	0	6	6	5	5	5	5
Financial account	1,444	1,061	702	238	1,112	1,230	1,067	894	897	942
Direct investment, net	921	478	375	128	650	530	475	450	425	450
Portfolio investment, net	-53	506	265	233	282	242	375	277	173	299
Other investment, net	575	77	63	-123	180	458	217	168	299	193
Net errors and omissions	285	-42	127	-150	0	0	0	0	0	0
Financing	-429	179	-157	57	-347	-451	-236	-19	-28	-14
Fund financing	-30	-17	-26	0	-35	-36	-40	-40	-32	-25
Change in official reserves (=increase)	-399	196	-131	57	-312	-414	-196	21	4	11
Official reserves and external debt										
Gross official reserves 1/	1,460	1,242	1,359	1,287	1,668	1,790	1,986	1,965	1,961	1,950
External gross debt 2/	3,741	4,528	4,856	5,106	5,117	5,261	5,615	5,937	6,273	6,615
Public and publicly guaranteed	1,687	2,392	2,364	2,461	2,632	2,603	2,637	2,622	2,457	2,602
Private	2,054	2,137	2,493	2,645	2,485	2,657	2,978	3,315	3,816	4,013
External net debt 4/	2,308	2,874	3,070	3,125	...	3,733	4,285	4,689	5,129	5,596
Public and publicly guaranteed	1,687	2,392	2,364	2,461	...	2,603	2,637	2,622	2,457	2,602
Private	621	482	706	665	...	1,130	1,648	2,067	2,672	2,994
Short-term external gross debt										
On a remaining maturity basis	1,730	1,899	1,605	...	1,767	1,908	2,146	2,396	2,565	...
On an original maturity basis	1,042	1,045	1,114	1,210	1,091	1,239	1,465	1,669	1,991	2,185
Of which:										
Trade credit	648	692	732	812	769	782	832	882	932	982
Currency and deposit at banks	145	189	247	236	230	269	322	374	409	445
Short-term external net debt 5/	88	-78	-59	-194	...	102	196	232	316	362
Debt service 3/	925	846	1,066	...	745	736	936	967	1,031	895
Amortization	765	688	854	...	502	491	669	681	727	573
Interest payment	160	158	212	58	242	245	266	286	304	322
(In percent of GDP)										
Current account	-12.1	-11.2	-6.0	-5.4	-6.5	-6.7	-6.6	-6.4	-5.8	-5.7
Trade balance of goods and services	-11.9	-10.3	-6.4	-3.4	-5.7	-6.8	-6.3	-6.0	-6.6	-6.3
Trade balance, goods	-14.1	-13.2	-9.8	-7.2	-9.4	-10.2	-9.6	-9.3	-9.8	-9.5
Of which:										
Non-energy trade balance	-8.2	-6.6	-3.2	0.0	-2.4	-3.3	-3.5	-3.8	-4.5	-4.3
Trade balance, services	2.2	2.9	3.4	3.7	3.7	3.4	3.3	3.3	3.1	3.2
Financial account	13.4	9.9	6.3	8.9	9.4	10.5	8.4	6.5	6.0	5.8
Direct investment, net	8.6	4.5	3.3	4.8	5.5	4.5	3.8	3.3	2.8	2.8
Portfolio investment, net	-0.5	4.7	2.4	8.7	2.4	2.1	3.0	2.0	1.2	1.8
Other investment, net	5.4	0.7	0.6	-4.6	1.5	3.9	1.7	1.2	2.0	1.2
External gross debt 2/	34.8	42.5	43.2	44.8	43.2	44.8	44.5	43.3	41.8	40.4
Public and publicly guaranteed	15.7	22.4	21.0	21.6	22.2	22.1	20.9	19.1	16.4	15.9
Private	19.1	20.0	22.2	23.2	21.0	22.6	23.6	24.2	25.5	24.5
External net debt 4/	21.5	27.0	27.3	27.4	...	31.8	33.9	34.2	34.2	34.2
Public and publicly guaranteed	15.7	22.4	21.0	21.6	...	22.1	20.9	19.1	16.4	15.9
Private	5.8	4.5	6.3	5.8	...	9.6	13.1	15.1	17.8	18.3
Short-term external gross debt										
On a remaining maturity basis	16.1	17.8	14.3	...	14.9	16.2	17.0	17.5	17.1	...
On an original maturity basis	9.7	9.8	9.9	10.6	9.2	10.5	11.6	12.2	13.3	13.4
Of which:										
Trade credit	6.03	6.49	6.52	7.1	6.5	6.66	6.59	6.44	6.22	6.00
Currency and deposit at banks	1.34	1.77	2.20	2.1	1.94	2.29	2.55	2.73	2.73	2.72
Debt service, in percent of exports of GNFS 3/	18.3	20.0	20.9	...	13.3	13.5	16.4	15.8	15.5	12.3
Amortization	15.1	16.2	16.7	...	9.0	9.0	11.7	11.2	11.0	7.9
Interest payment	3.15	3.73	4.15	4.18	4.3	4.48	4.67	4.69	4.58	4.42
Memorandum items:										
Nominal GDP (millions of U.S. dollars)	10,748	10,664	11,232	2,671	11,850	11,733	12,627	13,697	14,992	16,362
Exports of GNFS (percent change, y-o-y)	-2.9	-16.4	20.6	13.3	5.9	6.7	4.7	6.9	8.7	9.8
Imports of GNFS (percent change, y-o-y)	1.8	-15.9	9.3	11.2	7.6	7.2	4.1	6.5	10.1	9.0

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

1/ Gross official reserves reported here differ from the monetary survey because reverse repos involving major currencies in both legs are included.

2/ External liabilities minus equity investment.

3/ Debt service comprises interest and gross repayment on external loans, and interest and net repayment on debt securities.

4/ Total external liabilities minus total external assets, excluding foreign direct investment and reserve assets.

Table 4. Lithuania: Summary Monetary Accounts, 1998-2002

	1998	1999	2000	2001					2002
	Dec.	Dec.	Dec.	Mar.	Apr.	May	Dec.		Dec.
							Prev. proj.	Prog.	Proj.
(In millions of litai, unless otherwise indicated)									
<b>Monetary Authority</b>									
Net Foreign Assets	4,836	4,054	4,607	4,381	4,377	4,425	5,947	6,503	7,467
Net Domestic Assets	-575	35	-643	-683	-800	-776	-1,974	-2,459	-3,244
Net credit to government	-947	-326	-804	-854	-940	-871	-2,144	-2,515	-3,100
Credit to banks	52	30	24	23	24	16	24	24	24
Credit to private sector	7	6	6	5	5	5	6	6	6
Credit to nonbank financial institutions	7	20	0	0	0	0	20	10	10
Other items, net	305	305	120	125	93	59	120	16	-184
Reserve Money	4,260	4,088	3,964	3,698	3,577	3,649	3,973	4,044	4,222
Currency outside the central bank	3,036	2,972	2,904	2,714	2,751	2,713	2,939	2,989	3,164
Currency outside banks	2,800	2,739	2,658	2,511	2,502	2,493	2,739	2,789	2,964
Cash in vaults of banks	236	233	246	202	249	220	200	200	200
Deposit money banks' deposits	1,212	1,109	1,048	967	808	922	1,022	1,040	1,042
Reserves in litai	868	445	621	553	375	516	607	618	623
Required reserves in foreign currency	344	436	416	396	416	393	415	423	420
Private and non monetary financial institutions	13	7	12	18	17	14	12	15	16
<b>Monetary Survey</b>									
Net Foreign Assets	4,292	3,656	5,368	5,370	5,475	5,348	6,327	6,869	7,711
Monetary authority	4,836	4,054	4,607	4,381	4,377	4,425	5,947	6,503	7,467
Banks and other banking institutions	-544	-398	761	989	1,098	923	380	366	244
Net Domestic Assets	4,035	5,316	5,087	5,242	5,158	5,404	4,852	4,515	4,639
Net claims on government 1/	-505	39	299	303	356	478	-810	-795	-1,087
Monetary authority 2/	-947	-326	-804	-854	-940	-871	-2,144	-2,515	-3,100
Banks and other banking institutions 3/	441	365	1,103	1,156	1,296	1,348	1,334	1,720	2,013
Credit to non financial public enterprises	352	437	575	578	517	493	608	602	647
Credit to private sector 3/	4,874	5,545	5,209	5,396	5,328	5,378	5,799	5,705	6,262
Credit to nonbank financial institutions	470	468	514	539	561	598	543	537	577
Other items, net	-1,155	-1,168	-1,512	-1,574	-1,604	-1,542	-1,288	-1,535	-1,760
Broad Money	8,327	8,972	10,456	10,612	10,633	10,753	11,179	11,383	12,349
Currency outside banks	2,800	2,739	2,658	2,511	2,502	2,493	2,739	2,789	2,964
Deposits	5,527	6,233	7,797	8,101	8,131	8,259	8,440	8,594	9,386
In national currency	3,520	3,509	4,243	4,255	4,286	4,337	4,667	4,752	5,190
In foreign currency	2,007	2,725	3,554	3,846	3,844	3,923	3,773	3,842	4,196
<b>Memorandum items:</b>									
Reserve money (yearly percent change)	28.8	-4.0	-3.0	-0.4	-4.0	-1.7	0.2	2.0	4.4
Broad money (yearly percent change)	14.5	7.7	16.5	19.4	18.3	18.1	6.9	8.9	8.5
Private sector credit (yearly percent change) 3/	16.9	13.8	-1.2	3.0	0.9	0.6	11.3	9.5	9.8
Money multiplier	2.0	2.2	2.6	2.9	3.0	3.0	2.8	2.8	2.9
Currency / deposits, in percent	50.7	43.9	34.1	31.0	30.8	30.2	32.5	32.5	31.6
Foreign currency / litai deposits, in percent	57.0	77.7	83.8	90.4	89.7	90.5	80.9	80.9	80.9
Velocity of broad money 4/	6.0	4.9	4.6	...	...	...	4.4	4.3	4.3
Gross official reserves, in US\$ mln. 5/	1,462	1,244	1,344	1,278	1,269	1,279	1,668	1,790	1,986
GDP, mln. LTL	42,990	42,655	44,930	...	...	...	47,400	47,012	50,509

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

1/ Excludes local government deposits; includes counterpart funds.

2/ Projections for 2001 onwards include Treasury accounts, which will be moved from commercial banks to the BoL by end-June, 2001.

3/ December 2000 is adjusted for reclassification of LTL 270 million of DMB's claims on private sector to government lending funds, which were removed from balance sheets in July, 2000. If included, private credit would fall by 6.1 percent in 2000.

4/ Only annual average velocity is reported at year-end.

5/ Gross official reserves for historic data differ from BOP table because exposure under reverse repos was not reflected either in foreign assets or liabilities at the time of the program design. For projections, assumption is that all reverse repo transactions are unwound.



Table 5. Lithuania: Macroeconomic Framework, 1998-2005

	1998	1999	2000	2001	2002	2003	2004	2005
			Prel.	Prog.	Proj.			
(In percent of GDP, unless otherwise indicated)								
Gross national saving	12.3	11.5	14.7	15.2	15.4	15.9	17.1	17.6
General government	-0.7	-4.0	-0.4	0.7	0.8	0.3	1.6	2.0
Non-government	13.0	15.4	15.1	14.6	14.6	15.5	15.4	15.6
Gross national investment	24.4	22.7	20.7	21.9	22.0	22.3	22.9	23.3
General government	3.3	2.2	1.9	1.8	1.7	2.0	2.5	2.8
Non-government	21.1	20.4	18.7	20.1	20.3	20.3	20.4	20.4
Foreign saving 1/	12.1	11.2	6.0	6.7	6.6	6.4	5.8	5.7
General government financial balance 2/	-4.4	-6.2	-2.1	-1.3	-0.9	-1.7	-0.9	-0.8
General government net lending	1.5	2.4	0.7	0.1	0.4	0.0	0.0	0.0
Consolidated general government fiscal balance 2/	-5.9	-8.5	-2.8	-1.4	-1.3	-1.7	-0.9	-0.8
Current account balance	-12.1	-11.2	-6.0	-6.7	-6.6	-6.4	-5.8	-5.7
External debt 3/	34.8	42.4	43.2	44.8	44.5	43.3	41.8	40.4
Debt service (in percent of exports of GNFS)	18.3	20.0	20.9	13.5	16.4	15.8	15.5	12.3
Nominal GDP (in millions of Litai)	42,990	42,655	44,930	47,012	50,509	54,788	59,969	65,447
Real GDP growth (annual percentage change)	5.1	-3.9	3.3	3.6	4.7	5.2	5.6	6.0
Average CPI inflation (annual percentage change)	5.1	0.8	1.0	0.6	2.8	3.0	3.0	3.0
End-of-period CPI inflation (annual percentage change)	2.4	0.3	1.5	2.0	3.0	3.0	3.0	3.0

Sources: Lithuanian authorities; and Fund staff calculations.

1/ Negative current account balance.

2/ Includes discrepancy between above and below the line estimates of the financial balance and balances of budgetary organizations not recorded in the above the line number. Also includes savings restitution payments in 1998-99.

3/ External liabilities minus equity investment in Lithuania. Includes public, publicly guaranteed and private external debt.

Table 6. Lithuania: Schedule of Available Purchases under the Proposed Stand-By Arrangement, 2001-02

Amount of Purchase	Expected Availability	Contingent On
SDR 12.36 million (8.57 percent of quota)	August 30, 2001	Board Approval
SDR 12.36 million (8.57 percent of quota)	December 1, 2001	Observance of end-Sept. 2001 performance criteria, and completion of first review 1/
SDR 12.36 million (8.57 percent of quota)	March 1, 2002	Observance of end-Dec. 2001 performance criteria.
SDR 12.36 million (8.57 percent of quota)	June 1, 2002	Observance of end-March 2002 performance criteria, and completion of second review 1/
SDR 12.36 million (8.57 percent of quota)	September 1, 2002	Observance of end-June 2002 performance criteria
SDR 12.36 million (8.57 percent of quota)	December 1, 2002	Observance of end-Sept. 2002 performance criteria, and completion of third review 1/
SDR 12.36 million (8.57 percent of quota)	March 1, 2003	Observance of end-Dec. 2002

Source: Fund staff calculations.

1/ In addition to other clauses in the arrangement.

Table 7. Lithuania: Indicators of Financial Obligations to the Fund, 2001-08

	2001	2002	2003	2004	2005	2006	2007	2008
	Projections							
<b>Obligations from existing drawings 1/</b>								
Debt Service to the Fund (in millions of SDRs)	28.2	36.3	34.8	26.9	20.3	10.9	4.4	0.0
Repurchases (in millions of SDRs)	23.3	31.1	31.1	24.6	19.0	10.4	4.3	0.0
Charges (in millions of SDRs)	4.89	5.21	3.76	2.36	1.31	0.55	0.12	0.0
In percent of exports GNFS	0.7	0.8	0.7	0.5	0.4	0.2	0.1	0.0
In percent of external debt service	4.9	5.0	4.7	3.4	2.9	1.5	0.6	0.0
In percent of gross official reserves	2.0	2.4	2.3	1.8	1.4	0.7	0.3	0.0
Exports GNFS, in millions of US\$	5,453	5,711	6,106	6,635	7,283	7,865	8,494	9,174
External debt service, in millions of US\$	736	936	967	1,031	895	967	1,044	1,128
Gross official reserves, in millions of US\$	1,790	1,986	1,965	1,961	1,950	2,106	2,274	2,456
US\$/SDR exchange rate	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Quota, in millions of SDR	144	144	144	144	144	144	144	144
External debt, in millions of US\$	5,261	5,615	5,937	6,273	6,615	7,144	7,715	8,333
GDP, in millions of US\$	11,753	12,627	13,697	14,992	16,362	17,671	19,084	20,611
<b>Obligations from existing and prospective drawings 2/</b>								
Debt Service to the Fund (in millions of SDRs)	28.5	38.3	40.2	52.3	62.9	33.3	6.0	0.0
Repurchases (in millions of SDRs)	23.3	31.1	32.6	46.2	59.2	32.0	5.9	0.0
Charges (in millions of SDRs)	5.2	7.2	7.6	6.1	3.7	1.3	0.2	0.0
In percent of exports GNFS	0.7	0.9	0.9	1.0	1.1	0.6	0.1	0.0
In percent of external debt service	5.0	5.3	5.4	6.6	9.1	4.5	0.7	0.0
In percent of gross official reserves	2.1	2.5	2.7	3.5	4.2	2.1	0.3	0.0
<b>Memorandum items:</b>								
<b>Fund credit outstanding</b>								
<b>Without drawings under the stand-by arrangement</b>								
In millions of SDRs	120.3	89.3	58.2	33.6	14.7	4.3	0.0	0.0
In millions of US\$	155.5	115.5	75.5	43.7	19.1	5.6	0.0	0.0
In percent of quota	83.4	61.9	40.4	23.3	10.2	3.0	0.0	0.0
In percent of external debt	3.0	2.1	1.3	0.7	0.3	0.1	0.0	0.0
In percent of GDP	1.3	0.9	0.6	0.3	0.1	0.0	0.0	0.0
Exchange rate US\$/SDR	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
<b>With drawings under the prospective stand-by arrangement</b>								
In millions of SDRs	145.0	163.4	143.2	97.0	37.8	5.9	0.0	0.0
In millions of US\$	187.4	211.5	185.6	125.9	49.2	7.6	0.0	0.0
In percent of quota	100.6	113.3	99.3	67.3	26.2	4.1	0.0	0.0
In percent of external debt	3.6	3.8	3.1	2.0	0.7	0.1	0.0	0.0
In percent of GDP	1.6	1.7	1.4	0.8	0.3	0.0	0.0	0.0

Sources: Lithuanian authorities, and Fund staff estimates and projections.

1/ Assuming no drawings under the stand-by arrangement.

2/ Assuming all drawings are made under the prospective stand-by arrangement.

Table 8. Lithuania: Performance Criteria for Stand-By Arrangement, 2001-02 1/

	Target	Adjusted Target	Outcome 2/	
<b>Continuous performance criteria</b>				
<b>I. Exchange rate</b>				
LTL 4 per US\$1 3/	...	...	Observed through end-June	
<b>II. 100-percent coverage of currency board liabilities, in percent</b>				
	100	...	Observed through end-June	
<b>III. Reserve requirements, in percent 4/</b>				
	6	...	Observed through end-June	
<b>IV. Non-accumulation of new external payments arrears</b>				
	...	...	Observed through end-May	
<b>Quantitative performance criteria</b>				
<b>I. Ceiling on the general government deficit, mln. LTL</b>				
Cumulative from January 1, 2001				
March 31, 2001 (previous arrangement)	271	287	97	
June 30, 2001	460	...	...	
September 30, 2001	600	...	...	
December 31, 2001	679	...	...	
Cumulative from January 1, 2002				
March 31, 2002	232	...	...	
June 30, 2002	420	...	...	
<b>II. Floors on net foreign exchange coverage of the currency board arrangement, mln. US\$</b>				
<b>Stocks</b>				
March 31, 2001 (previous arrangement)	-127	...	-39	
June 30, 2001	-127	...	-31	
September 30, 2001	-127	...	...	
December 31, 2001	-127	...	...	
March 31, 2002	-127	...	...	
June 30, 2002	-127	...	...	
<b>III. Ceilings on contracted public and publicly guaranteed medium- and long-term external debt; mln. US\$</b>				
	All maturities	1-5 year maturity (medium- and long-term)	All maturities	1-5 year maturity
Cumulative from January 1, 2001				
March 31, 2001 (previous arrangement)	293	200	183	0
June 30, 2001	433	200	...	...
September 30, 2001	648	200	...	...
December 31, 2001	683	200	...	...
Cumulative from January 1, 2002				
March 31, 2002	450	200	...	...
June 30, 2002	500	200	...	...
<b>IV. Ceilings on the outstanding stock of public and publicly guaranteed short-term external debt; mln. US\$</b>				
<b>Maximum stock during the period</b>				
March 31, 2001 (previous arrangement)	0	...	...	0
June 30, 2001	50	...	...	...
September 30, 2001	50	...	...	...
December 31, 2001	50	...	...	...
March 31, 2002	200	...	...	...
June 30, 2002	200	...	...	...

Source: Ministry of Finance; and Fund staff estimates.

1/ Definitions and exclusions are presented in the Technical Memorandum of Understanding.

Numbers for end-June 2001 are indicative targets, numbers for end-September 2001 and end-December 2001 are performance criteria, and numbers for end-March 2002 and end-June 2002 are indicative targets.

2/ Based on latest available data.

3/ This performance criterion will be modified at the time of the repegging.

4/ This is consistent with the required reserve ratio of 8 percent.

Table 9. Lithuania: Quantitative Benchmarks for Stand-By Arrangement, 2001-02

	Ceiling	Outcome
I. Domestic guarantees, mln. LTL		
Outstanding stock		
March 31, 2001 (previous arrangement)	319	217
September 30, 2001	314	...
December 31, 2001	312	...
March 31, 2002	305	...
June 30, 2002	300	...
II. Central government arrears, mln. LTL		
Outstanding stock		
March 31, 2001 (previous arrangement)	0	19
September 30, 2001	0	...
December 31, 2001	0	...
March 31, 2002	0	...
June 30, 2002	0	...

Source: Ministry of Finance; and Fund staff estimates.

Table 10. Lithuania: Structural Benchmarks for Stand-By Arrangement, 2001

Measure	Date
Submit to Seimas draft amendments to the Law on Revenue Redistribution of Municipalities	end-September
Submit to Seimas draft amendments to the Privatization Law for establishing the Reserve Stabilization Fund	end-September
Tender for privatizing the Agricultural Bank	end-September
Government's decision on a set of measures to overhaul municipal finances	end-December
Submit to Seimas draft amendments to the Law on Social Security needed for the pension reform	end-December
Submit to Seimas legal amendments on accounting standards	end-December
Submit to Seimas the draft unemployment insurance law and the proposed new labor code	end-December

Source: Ministry of Finance; and Fund staff estimates.

Table 11. Lithuania: Indicators of External and Financial Vulnerability, 1998-2001

	1998	1999	2000				2001			Date
			Mar.	Jun.	Sep.	Dec.	Year	Mar.	Latest	
<b>Financial indicators</b>										
State debt (domestic and foreign, in percent of GDP) 1/	22.4	28.4	30.5	30.1	29.1	28.3	28.3	28.8	28.8	Q1/2001
Broad money (year-on-year change in percent)	14.5	7.7	9.1	5.8	11.8	16.5	16.5	19.4	17.2	Q2/2001
Broad money in percent of gross official reserves	142.6	180.6	160.7	163.8	182.7	192.4	192.4	206.2	188.0	Q2/2001
Private sector credit (year-on-year change in percent) 2/	16.9	13.8	0.0	-2.4	-8.8	-6.1	-6.1	3.0	1.2	Q2/2001
<b>External indicators</b>										
Current account balance in percent of GDP	-12.1	-11.2	-5.7	-6.1	-3.5	-8.7	-6.0	-5.4	-5.4	Q1/2001
Exports of GNFS (year-on-year change in percent)	-2.9	-16.4	23.5	16.1	22.2	20.5	20.6	15.3	15.3	Q1/2001
Imports of GNFS (year-on-year change in percent)	1.8	-15.9	16.9	1.9	10.6	9.1	9.3	11.2	11.2	Q1/2001
Capital and financial account balance in percent of GDP	13.4	9.9	9.0	6.7	0.5	9.5	6.3	8.9	8.9	Q1/2001
Gross official reserves (in millions of U.S. dollars) 3/	1,460	1,242	1,382	1,424	1,349	1,359	1,359	1,287	1,455	Q4/2000
Gross official reserves/short-term debt 4/	0.84	0.65	0.69	0.69	0.73	0.85	0.85	...	0.85	Q4/2000
Gross official reserves/reserve money	1.37	1.22	1.50	1.52	1.43	1.37	1.37	1.40	1.52	Q2/2001
Gross official reserves in months of imports of GNFS over the following year	3.3	2.6	2.7	2.8	2.6	2.6	2.6	2.4	2.4	Q1/2001
Net foreign assets of financial sector (in millions of U.S. dollars) 5/	-120	-79	69	66	163	187	187	244	160	Q2/2001
Total external gross debt (in millions of U.S. dollars) 6/	3,739	4,525	4,741	4,845	4,729	4,856	4,856	5,106	5,106	Q1/2001
in percent of GDP	34.8	42.4	43.9	44.7	43.0	43.2	43.2	44.8	44.8	Q1/2001
in percent of exports GNFS (over the last four quarters)	73.7	106.8	106.1	110.0	96.7	95.1	95.1	96.4	96.4	Q1/2001
of which: Public sector debt (in millions of U.S. dollars)	1,670	2,383	2,552	2,527	2,364	2,364	2,364	2,461	2,461	Q1/2001
in percent of GDP	15.5	22.3	23.6	23.3	21.5	21.0	21.0	21.6	21.6	Q1/2001
of which: Short-term external debt (in millions of U.S. dollars) 4/	1,730	1,899	2,001	2,077	1,853	1,605	1,605	...	1,605	Q4/2000
in percent of GDP	16.1	17.8	18.5	19.2	16.9	14.3	14.3	...	14.3	Q4/2000
Total external net debt (in millions of U.S. dollars) 7/	2,308	2,874	3,050	3,070	2,882	3,070	3,070	3,125	3,125	Q1/2001
in percent of GDP	21.5	27.0	28.2	28.3	26.2	27.3	27.3	27.4	27.4	Q1/2001
in percent of exports GNFS (over the last four quarters)	...	68	68	67	59	60	60	59	59	Q1/2001
of which: Public sector debt (in millions of U.S. dollars)	1,687	2,392	2,631	2,527	2,364	2,364	2,364	2,461	2,461	Q1/2001
in percent of GDP	16	22	24	23	22	21	21	22	22	Q1/2001
of which: Private sector debt (in millions of U.S. dollars)	621	482	419	543	518	706	706	664.8	664.8	Q1/2001
in percent of GDP	5.8	4.5	3.9	5.0	4.7	6.3	6.3	5.8	5.8	Q1/2001
Total external net short-term debt (in millions of U.S. dollars)	88	-78	-116	-137	-206	-59	-59	-194	-194	Q1/2001
in percent of GDP	0.8	-0.7	-1.1	-1.3	-1.9	-0.5	-0.5	-1.7	-1.7	Q1/2001
External interest payments in percent of exports GNFS	3.2	3.7	5.2	4.2	4.5	2.8	4.1	4.2	4.2	Q1/2001
External amortization payments in percent of exports GNFS	15.1	16.2	6.7	9.2	18.1	31.8	16.7	31.8	31.8	Q1/2001
Public and publicly guaranteed debt service as percent of tax revenue	9.2	13.0	7.7	9.3	25.4	8.7	12.7	8.7	8.7	Q1/2001
Debt service as percent of exports of GNFS	18.3	20.0	15.0	13.4	22.6	34.6	20.9	34.6	34.6	Q1/2001
Real effective exchange rate (year-on-year change in percent, "+" = appreciation) 8/	9.6	4.2	3.3	3.2	9.0	1.6	6.6	0.0	0.0	5/30/01
<b>Financial market indicators</b>										
Stock market index, end of period 9/	1,089	1,089	1,137	1,046	1,036	1,047	1,047	1,007	823	7/13/01
Foreign currency debt rating 10/	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	7/20/01
Spread of benchmark bonds (basis points, end of period) 11/	317	339	207	205	181	217	198	221	172	6/30/01
<b>Memorandum items:</b>										
GDP (in millions of U.S. dollars)	10,748	10,664	2,499	2,805	3,007	2,922	11,232	2,671	2,671	Q1/2001
Nominal exchange rate (litai/U.S. dollar, end-of-period)	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	7/26/01
Nominal exchange rate (litai/euro, end-of-period)	...	4.0	3.8	3.8	3.5	3.6	3.7	3.4	3.5	7/26/01

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

1/ Public and publicly guaranteed debt, excluding short-term debt of SoDra and nonguaranteed debt of municipalities.

2/ Includes reduction of claims on private sector of LTL 270 million in July, 2000.

3/ Gross official reserves reported here differ from the monetary survey because here reverse repos involving major currencies in both legs are included.

4/ On a remaining maturity basis.

5/ Deposit money banks.

6/ External liabilities minus equity investment in Lithuania.

7/ Total external liabilities minus total external assets, excluding foreign direct investment and reserve assets.

8/ CPI-based REER against the 21 major trading partners in 1999.

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

10/ S&P investment grade rating.

11/ Monthly average spread of 5-year Eurobond (US\$200 million) issued in July 1997 above the rate on a synthetic U.S. treasury bond with same maturity.

Table 12. Lithuania: Indicators of Financial Sector Vulnerability, 1997-2001  
(In percent, unless otherwise indicated)

	1997	1998	1999				2000				2001
			Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.
Private sector credit (percentage change, year-on-year) 1/	18.9	16.9	17.0	17.5	16.8	13.8	0.0	-2.4	-8.8	-1.2	3.0
Loans to private enterprises	3,167	3,493	3,625	3,892	3,927	3,858	3,573	3,714	3,629	3,715	3,792
Loans to private enterprises (percentage change, year-on-year)	...	10.3	...	...	...	10.4	-1.4	-4.6	-7.6	-3.7	6.1
Share of loans to private enterprises in total lending	76.3	67.8	67.0	66.7	65.5	65.3	62.7	63.4	63.8	62.8	62.2
Commercial bank reserves (in percent of deposits) 2/	15.7	26.2	20.5	17.9	18.2	21.5	17.9	16.3	15.6	16.4	14.2
Cash	4.0	4.3	3.8	3.4	3.1	3.7	2.7	2.5	2.1	3.1	2.5
Reserves held at the BOL	11.6	21.9	16.6	14.5	15.1	17.8	15.2	13.8	13.6	13.3	11.7
Required reserves (in percent of total reserves)	70.7	59.9	75.2	88.0	83.0	69.8	85.7	85.4	85.5	71.6	76.1
Official risk indicators 3/											
Share of non-performing loans in total loans 4/	28.3	12.9	12.2	10.9	9.1	12.5	15.1	16.5	14.0	11.3	12.0
Risk-weighted capital asset ratio (capital over risk-weighted assets) 5/	10.8	23.8	22.7	22.6	22.1	17.4	18.0	16.4	16.7	16.3	16.4
Leverage ratio 6/	5.9	14.9	14.8	15.2	14.7	11.1	11.1	10.3	10.4	10.2	10.5
Share of private sector credit collateralized by real estate	12.9	12.0	11.5	11.2	11.3	10.3	10.7	10.5	9.3	9.7	9.0
Financial sector risk factors of DMB's											
Share of foreign currency loans in total lending	39.7	55.9	57.5	59.3	58.7	61.6	63.7	64.1	66.9	66.8	64.4
Share of foreign currency deposits in total deposits	38.9	41.9	41.1	43.2	46.4	48.8	48.9	48.4	48.0	49.5	48.7
Short-term loans in percent of total loans	61.1	45.9	44.7	42.7	43.4	41.0	42.2	39.7	37.6	37.9	36.0
Demand deposits in percent of total deposits	66.8	62.3	58.2	55.1	51.8	51.4	50.0	49.1	49.9	48.9	46.6
Market assessment											
Share price of Vilniaus Banka (in LTL, end of period)	229	29	28	27	23	26	31	30	40	50	50
Spread between VILIBID and VILIBOR 7/ 8/	500	268	232	203	240	295	296	254	264	233	199
Open position in foreign exchange 9/ 10/	...	...	...	...	-3.3	6.0	12.4	7.9	4.4	3.8	4.1
Total loans (in millions)	4,150	5,150	5,412	5,834	5,997	5,911	5,695	5,860	5,686	5,916	6,093
Total deposits (in millions)	6,006	6,670	6,702	7,019	7,296	7,450	7,638	8,136	8,858	9,176	9,653

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

1/ End-year private sector credit growth excludes reclassified loans of LTL 270 million, which were removed from banks' books in July, 2000. If this amount is included, private sector credit falls by 6.1 percent in December, 2000.

2/ Excludes central government deposits.

3/ Prudential standards are broadly at international levels, and there is a full program of on-site and off-site supervision. Foreign bank branches are not included.

4/ Includes loans overdue for 31 days. The classification of loans may be adjusted according to the borrower's standing, loan restructuring and refinancing (Resolution on the Board of the Bank of Lithuania on the Approval of the Regulations for Classification of Doubtful Assets, April 24, 1997 No. 87).

5/ The compilation of the minimum capital adequacy ratio was aligned with the Basle methodology on January 1, 1997.

6/ Defined as the ratio of total capital to total liabilities.

7/ Interbank rates, basis points.

8/ As of January 1, 1999, the spread between the average overnight Vilnius Interbank Offered rate (VILIBOR) and the average overnight Vilnius Interbank Bid rate (VILIBID) during the respective month; before January 1, 1999, the spread between the average of the highest and lowest VILIBOR and the average between the highest and lowest VILIBID.

9/ Open position includes off-balance exposure.

10/ Maximum open position requirements have been reduced as of June 1, 2000. Maximum in foreign currency and precious metals is 25 percent of a bank's capital, while earlier it was 30 percent. Maximum in each currency is 15 percent, while earlier it was 20 percent.



**FUND RELATIONS**  
(As of June 30, 2001)

I. **Membership Status:** Joined: 04/29/1992; Article VIII.

II. <b>General Resources Account:</b>	<b>SDR Million</b>	<b>Percent of Quota</b>
Quota	144.20	100.0
Fund holdings of currency	279.17	193.6
Reserve position in Fund	0.02	0.0

III. <b>SDR Department:</b>	<b>SDR Million</b>	<b>Percent of Allocation</b>
Holdings	0.44	N.A.

IV. <b>Outstanding Purchases and Loans:</b>	<b>SDR Million</b>	<b>Percent of Quota</b>
Extended arrangements	111.26	77.2
Systemic Transformation	23.72	16.4

V. **Latest Financial Arrangements:**

Type	<b>Approval Date</b>	<b>Expiration Date</b>	<b>Amount Approved (SDR Million)</b>	<b>Amount Drawn (SDR Million)</b>
Stand-by	03/08/2000	06/07/2001	61.80	0.00
EFF	10/24/1994	10/23/1997	134.55	134.55
Stand-by	10/22/1993	10/24/1994	25.88	5.18

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

	<b>Overdue 4/30/01</b>	<b>Forthcoming</b>				
		<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Principal		14.7	31.1	31.1	24.6	19.0
Charges/Interest		<u>2.9</u>	<u>4.7</u>	<u>3.4</u>	<u>2.1</u>	<u>1.2</u>
Total		17.6	35.8	34.5	26.7	20.2

VII. **Exchange Arrangement:**

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

VIII. **Resident Representative:**

The resident representative of the Fund in Lithuania is Mr. Mark Horton, who took up his post in October 1999.

IX. **Consultation Cycle:**

Lithuania is on the 12-month consultation cycle.

### LITHUANIA: WORLD BANK RELATIONS

1. Since Lithuania joined the World Bank in 1992, the Bank's assistance to the country has concentrated on reforms in key areas such as preserving macroeconomic stabilization to build and maintain investor confidence, reducing government involvement in business activities, and enforcing the basic legal tenets necessary for private activity. Moreover, the Bank is assisting in reorienting the social safety net, public services, infrastructure, and the energy sector to the needs of a market economy.
2. The table below provides a summary of IBRD loans as of March 8, 2001. It includes 15 projects and SALs with commitments totaling US\$448.36 million equivalent and disbursements on all Bank projects in Lithuania amounting to US\$234.15 million and €54.88 million. A Structural Adjustment Loan II for the period July 1, 2000-June 30, 2001 in the amount of US\$98.5 million was approved in July 2000. Preparation of other operations is proceeding in the areas of infrastructure, education, and municipal services.
3. Projects approved by IFC amount to US\$104.5 million as of December 2000. The portfolio consists of the following projects: (i) modernization and expansion of a privatized, export-oriented wool mill (US\$11.6 million); (ii) modernization of a color picture tubes factory (US\$15 million); (iii and iv) construction of a margarine production plant (US\$1.025 million) and an asphalt production plant (US\$1.7 million) (both are sub-projects of a line of credit to support SMEs); (v) upgrading of fabric forming and finishing operations of a wool worsted fabric producer (US\$6.6 million); and (vi) subordinated loan to strengthen the capital basis of a bank (US\$20 million). The following projects have been approved by the Board: (i) modernization of production facility and financial restructuring of a plywood and particleboard manufacturer (US\$2.75 million);<sup>1</sup> and (ii) expansion, modernization and financial restructuring of a paperboard mill (US\$2 million).
4. Lithuania is a member of MIGA, which has so far not issued any guarantees, but has four applications pending. Government representatives have participated in MIGA-sponsored meetings on investment promotion, and Lithuania is an active user of MIGA's Internet-based information dissemination facilities. FIAS has completed a study of administrative barriers to investment.
5. The first World Bank Country Economic Memorandum was published in April 1993. A Public Expenditure Review was conducted in 1993/94 and was the basis for a donor meeting on public investments in May 1995. The Bank also has prepared an informal enterprise and financial sector study, a private sector assessment, a comprehensive energy sector review, a study of nuclear energy alternatives commissioned by the G-7, an agricultural review, a municipal finance study, a social insurance/social policy note, and an informal note on transport. In 1998, the Bank completed a multi-sectoral collection of policy notes, and a Country Assistance Strategy for 1999-2001, which were discussed by the Board on May 11, 1999. A Macro Financial Vulnerability Study was completed in 1999.

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<sup>1</sup> Likely to be canceled.

World Bank Loans Approved by the Board  
(As of March 8, 2001, in millions of U.S. dollars)

	Commitments	Disbursements
Rehabilitation Loan 1/ (effective October 1992)	60.0	58.8
SAL I (effective October 1996) 2/	80.0	80.0
Highway Project (effective September 1996) 3/	19.0	19.0
Power Rehabilitation and Restructuring (effective November 1995)	26.4	17.87
Environment (Klaipeda) (effective May 1995)	7.0	3.94
EFSAP (effective December 1995)	25.0	21.00
Environment (Siauliai) (effective December 1996)	6.2	5.99
Agricultural Development Project (effective August 1996)	30.0	7.98
Klaipeda Geothermal (effective October 1996)	5.9	4.41
Energy/Housing Pilot (effective November 1996)	10.0	8.18
Social Policy (effective January 1998)	3.7	2.22
Municipal Development (effective October 2000)	20.1	0.19 (€)
Health Project (effective May 2000)	21.2	0.91
SAL II (effective July 2000)	98.5	54.69 (€)
Klaipeda Port (effective October 2000)	35.36	3.85
<b>Total</b>	<b>448.36</b>	<b>US\$234.15</b> <b>€54.88</b>

Source: The World Bank.

1/ Loan closed in December 1995; US\$1.2 million canceled.

2/ Loan closed in June 1998

3/ Loan closed in April 2000

## LITHUANIA: TECHNICAL ASSISTANCE FROM THE FUND, 1997-2001

Department	Issue	Action	Date	Counterpart
FAD	Treasury operations	Mr. Ramachandran	Feb/Mar. 1997	Ministry of Finance
FAD	Treasury operations	Mr. Ramachandran	Jun. 1997	Ministry of Finance
FAD	Treasury operations	Mr. Ramachandran	Aug/Sep. 1997	Ministry of Finance
STA	Balance of payments statistics	Mr. Allen	Aug/Sep. 1997	Department of Statistics
FAD	Treasury operations	Mr. Ramachandran	Nov/Dec. 1997	Ministry of Finance
MAE	Monetary policy and banking supervision	Mission	Dec. 1997	Bank of Lithuania
STA	National accounts and balance of payments	Mr. Gschwindt de Gyor	Dec. 1997	Department of Statistics
FAD	Treasury operations	Mr. Ramachandran	Jan. and April 1998	Ministry of Finance
STA	Multipurpose statistics	Mr. Allen	Resident Advisor, 1997-98	Department of Statistics, Bank of Lithuania, and Ministry of Finance
STA	Balance of payments	Mr. Gschwindt de Gyor	April 1999	Department of Statistics and Bank of Lithuania
FAD	Expenditure policy	Mission	June/July 99	Ministry of Finance
FAD	Treasury operations	Mission	November 1999	Ministry of Finance
MAE	Monetary policy	Mr. Ketterer	Resident Advisor, May 1997-November 1999	Bank of Lithuania
STA	Balance of payments statistics (also covering Latvia)	Mr. Buxton	Resident Advisor, October 1999-October 2000	Bank of Lithuania
LEG	Bankruptcy legislation	Mr. Dimitrachkov	March 2000	Ministry of Economy
FAD	Establishment of Fiscal Reserve Fund	Mission	July 2000	State Privatization Fund
MAE	Multi-topic	Mission	March 2001	Bank of Lithuania
FAD	Tax policy issues	Mission	June 13-26	Ministry of Finance
MAE/WB	FSAP	Mission	July 2-13	Bank of Lithuania and Ministry of Finance

### LITHUANIA: STATUS OF STATISTICAL DATABASE

1. Over the past several years, Lithuania has made good progress in establishing a macroeconomic database. Official data for all sectors are generally of sufficiently good quality to support economic analysis. However, frequent and large revisions of national accounts and balance of payments data tend to complicate the analysis of economic developments.
2. In general, the data are available on a timely basis, and the authorities have given the staff ready access to all available data (see the attached matrix). An IFS page for Lithuania was introduced in December 1995. In May 1996, the Lithuanian authorities subscribed to the Special Data Dissemination Standard, and its metadata have been posted on the Fund's Dissemination Standards Bulletin Board (DSBB) on the Internet since April 1997. A significant amount of information is now available on various websites through the Internet (see section on Dissemination of Statistics, below).

#### **National accounts**

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

#### **Price data**

4. Since December 1998, the CPI weights for the national level market basket have been updated each year. The last update was undertaken in December 1999 and based on the Household Budget Survey (HSB) covering the period October 1998 to September 1999. The monthly CPI is available in the second week of the following month. The producer price

index is calculated according to the chain-linked Laspeyres formula. Data on investment or tradable goods price indices are not yet available.

### **Public finance**

5. Data on the central government budget execution are available quarterly in the standard GFS format, although these data are subject to frequent revisions. The ongoing treasury project is expected to improve data quality substantially. The budget data are only compiled on a cash basis; compilation of the budget data on an accrual basis would allow monitoring of arrears and facilitate forecasting of future budgetary flows. In January 1999, the Ministry of Finance began publishing data on monthly consolidated general government operations, which include the national government (state and municipalities) and some extrabudgetary funds. Further work is needed to include all extrabudgetary funds and eliminate intra-government transfers in the consolidation of general government operations.

### **Money and banking**

6. The accounts of the BoL for the end of each month are available in the second week of the following month, while the consolidated accounts of banking institutions are available within the month following the month of reference. The sectorization and classification of the accounts follow the methodology of the *Monetary and Financial Statistics Manual*.

### **External sector**

7. The BoL is responsible for compiling the balance of payments, the international investment position and the international reserves statistics. The BoL compiles balance of payments statistics on a quarterly basis using the format recommended in the *Balance of Payments Manual*, fifth edition (BPM5). In 1999, BoL set in motion plans to develop and produce monthly balance of payments statistics to meet the requirements of the EU following Lithuania's application for membership of the EU.

8. STA assigned a balance of payments statistics advisor to Lithuania during the period October 1999-October 2000, who also covered Latvia. The mission concluded that the methodology used to compile Lithuanian balance of payments statistics is, for the most part, sound and that the BoL has made progress in developing a monthly balance of payments series and in its compilation of travel and transfers. It also found that it has significantly reduced the errors and omissions item, to less than 2 percent of GDP for the second quarter of 2000. During that period BoL made improvements in several areas, most notably in refining its technique for estimating travel expenditures, drawing upon additional data sources for private transfers and further developing its methodology for adjusting the value of exports from warehouses. As a result of work undertaken to produce monthly statistics, the BoL has also developed the methodology and data sources needed for compiling monthly balance of payments series. The new monthly surveys draw heavily on existing sources (available survey, administrative and other), as well as new monthly surveys of banks and a sample of nonfinancial enterprises. In addition, it has incorporated an additional source, by

setting a new monthly international transactions reporting system. The new framework was set up on a pilot basis in November 2000 and should reach an acceptable level in 2001.

9. However, some problems remain in the estimation of merchandise trade transiting through Customs-bonded warehouses, regarding the value between the reception and shipment of the merchandise. The scope of smuggling and shuttle trade is also deemed underestimated in trade data. The current transfers do still underestimate the private transfer due to lack of appropriate sources. In the financial flows accounts, existing estimation methods also misstate several key components of other investment flows, especially for banks. This should be corrected by the new banking report, which will be used for estimating all current and financial account items for the banking sector, including the direct investment flows of the sector. The authorities should give priority to implementing the mission's recommendations in a timely and effective manner.

10. As a subscriber to the Special Data Dissemination Standard (SDDS), Lithuania is among the countries disseminating data on international reserves and foreign currency liquidity in the framework of the *Operational Guidelines—Data Template on International Reserves and Foreign Currency Liquidity*. The reporting format and the dissemination timeliness meet SDDS requirements.

#### **Dissemination of statistics**

11. The Lithuanian authorities publish a range of economic statistics through a number of publications, including the DOS's monthly publication, *Economic and Social Developments*, and the BoL's monthly *Bulletin*. A significant amount of data are available on the Internet:

- Lithuania's metadata for data categories defined by the Special Data Dissemination Standard are posted on the IMF's DSBB;
- The BoL website (<http://www.lbank.lt>) provides data on monetary statistics, treasury bill auction results, balance of payments, the international investment position, and main economic indicators;
- The DOS website (<http://www.std.lt>) provides quarterly information on economic and social development indicators;
- The Ministry of Finance (<http://www.finmin.lt>) home page includes data on the national budget, as well as information on laws and privatization; and
- The National Stock Exchange website (<http://www.nse.lt>) has information on stock trading.

Core Statistical Indicators  
(As of July 26, 2001)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	Public External Debt
Date of latest observation	07/26/01	06/30/01	05/31/01	05/31/01	05/31/01	05/31/01	June 2001	May 2001	Q1 2001	Q1 2001	Q1 2001	Q1 2001
Date received	07/26/01	07/08/01	6/18	6/18	6/25	6/13	07/10/01	07/16/01	04/06/01	05/21/01	07/02/01	06/21/01
Frequency of data	D	M	M	M	M	M	M	M	Q	M	Q	M
Frequency of reporting	D	M	M	M	M	M	M	M	Q	M	Q	M
Source of data	C	A 1/	A 1/	A 1/	A 1/	A 1/, C	C	A 1/, C	A 1/ C	A 1/	A, N 1/	A
Mode of reporting	E	C,E	C,E	C,E	C,E	C,E	E	C,E	C,E	C	C	V
Confidentiality	C	C	C	B	C	C	C	C	C	C	C	C
Frequency of publication	D	M	M	M	M	M	M	M	Q	M	Q	M

1/ Through the resident representative office.

Notes:

Frequency of data: D-daily, W-weekly, M-Monthly, Q-Quarterly.



## LITHUANIA—ILLUSTRATIVE MEDIUM-TERM MACROECONOMIC AND FISCAL SCENARIO

1. The staff prepared a stylized macroeconomic scenario for 2001-05 with a focus on public finances. This scenario is based on agreed tax measures for the period covered by the program (2001-02) and staff's recommendations for tax reforms and expenditure adjustment for 2003-05. Table 5 shows the summary of major macroeconomic indicators, which reflect the staff's judgment on the impact of tax measures, changes in the composition of expenditure, and external developments on major GDP expenditure components. Tables 2 and 3 present the general government operations and balance of payments, respectively.

### A. Medium-Term Framework

2. Real GDP growth is expected to accelerate from 3.6 percent in 2001 to 5-6 percent a year over the medium term. Growth would be underpinned primarily by the recovery of domestic demand and continued good export performance during 2002-03, and subsequently, EU accession, assumed in 2004, would give an additional impetus to growth acceleration. Even if EU accession occurs one or two years later, the underlying trends of this scenario remain valid, but growth acceleration would be stretched over a longer period of time.

3. In 2002-03, internal demand would be stimulated by the ongoing cyclical recovery, structural reforms, changes to the tax system (see below), and strengthened investors' and consumers' confidence in the run-up to EU accession. Consumption and investment would be further boosted by greater integration with the EU. Moreover, the full impact of gradual tax reforms would bear fruits in terms of growth and employment after its completion in 2004 and beyond.

4. During 2001-05, wages are projected to increase by 3 to 4 percent in real terms and unemployment is projected to decline, as a result of the strengthening of the recovery, further liberalization of the labor market, and, to some extent, the projected reduction in labor taxation. These labor market developments would contribute to the strengthening of the tax bases for the payroll and personal income taxes. Inflation would remain around 2-3 percent, reflecting faster productivity growth than in trading partners.

5. Gross national saving would increase from 14.7 percent of GDP in 2000 to 17.6 percent of GDP in 2005 on account of growth of both public and private savings. Public savings will increase from -0.4 percent of GDP in 2000 to 0.8 percent of GDP in 2002. A drop of public savings to 0.3 percent of GDP in 2003 would reflect the projected reduction in payroll tax revenue by 1 percent of GDP due to the pension reform. Afterwards public savings would increase to 2 percent of GDP by 2005 reflecting further fiscal consolidation and use of large EU transfers for capital spending. Private savings would decline from 15.1 percent of GDP in 2000 to 14.6 percent in 2001, reflecting the projected pick-up in private consumption. In 2003, private savings would increase by around 1 percent of GDP to 15.5 percent, as the payroll tax revenue diverted to the privately funded second pillar of the pension system would be saved and private savings outside the pension system would remain largely unaffected by the pension reform. Private savings are projected to remain around this

level in the medium-term because a large portion of consumers are likely to be liquidity constrained, implying that they would have a relatively stable marginal propensity to save outside the pension system irrespective of policy change. The lack of even weak partial Ricardian equivalence (stable private savings despite a significant strengthening of public savings) could also be justified by increasing returns on investment and an increasingly sophisticated financial system.<sup>1</sup>

6. Despite the projected decrease in reliance on foreign savings, the higher level of national savings would allow investment to increase from 20.7 percent of GDP in 2000 to 23.3 percent of GDP in 2005. Given liberal capital account regulations and greater integration with the EU, increasingly large capital inflows will finance private investment, while Lithuanian investment abroad will also increase in part due to private pension fund investments.

7. The external current account deficit would stay around 6 percent of GDP in the medium term, supported by the maintenance of fiscal discipline, as well as further improvement in Lithuania's competitiveness brought about by structural reforms. The projected current account deficit path, while showing a small adjustment in 2001-05, is consistent with a strengthening of external viability. A large share of FDI in external financing, access to foreign financing at low spreads, and rapid growth would lead to a further reduction in external debt ratios.

8. Over the medium term, a sustained growth path is projected for the period of 2002-03 for both exports and imports, with the former growing at a slightly faster pace, leading to a steady reduction of the current account deficit. Export growth would be driven by a further penetration to EU markets and a continued expansion of services. The EU accession would have a major impact on the current account. Lithuania is projected to receive net transfers in the amount of about LTL 900 million per annum (1¾ percent of GDP) from 2004 onwards, and consequently, imports would increase significantly on account of a pick-up in EU-related investment. As the stage of large-scale privatization comes to an end after 2002, privatization-related FDI inflows would start to diminish. FDI inflows over the medium term are projected to be maintained at a stable albeit lower level, as non-privatization related FDI inflows would increase, owing to an improved business environment, sustained economic growth, and integration with the EU. Portfolio and other investment inflows, which would be underpinned by full access to international capital market by the private sector, as well as the government, are projected to grow steadily. Overall external debt would decline gradually in terms of GDP, with the private sector overtaking the public sector as the major borrower. Official reserves would reflect the projected development of money demand and government deposits, including the RSF, at the Central Bank.

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<sup>1</sup> This assumption is in line with the empirical evidence for Lithuania presented in SM/00/121.

## B. Fiscal Policy

9. The pace of the tax reform was adjusted to be consistent with a feasible path of expenditure consolidation and its re-orientation toward EU accession, and the need to continue a gradual adjustment of the fiscal deficit. It is projected that the fiscal deficit, excluding the cost of the pension reform,<sup>2</sup> would be gradually eliminated by the time of EU accession when economy could reach potential output.<sup>3 4</sup> At the same time, expenditure would stay at around 30-31.5 percent of GDP to meet various government's expenditure obligations,<sup>5</sup> relating to EU and NATO accession,<sup>6 7</sup> the pension reform, and the binding

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<sup>2</sup> It is assumed that the cost of the pension reform would be 1 percent of GDP and would be financed by privatization proceeds during 2003-05.

<sup>3</sup> On the basis of the projected evolution of the cyclically-adjusted fiscal balance, the structural fiscal deficit is tentatively estimated at about 0.5-0.8 percent of GDP in 2001 (footnote 4).

<sup>4</sup> The estimates of the structural deficit should be interpreted with caution since the availability of historical data used to estimate potential output and other parameters is very limited. The potential output is estimated by applying the Hodrick-Prescott (HP) filter to a quarterly real GDP series formed by historical data for the period 1995Q1-2000Q4 and projections for the period 2001Q1-2005Q4. Projections are used to avoid end-period distortions induced by the HP filter when only historical data are considered (Kaiser R. and A. Maravall, 1999, *Spanish Economic Review*, 1, 175-206). Revenue and expenditure elasticities and other parameters used in the calculations of the cyclically-adjusted fiscal balance are computed following the OECD methodology and are based on empirical evidence from Lithuania and other countries (OECD, ECO/WKP(2000),3).

<sup>5</sup> Assumptions on expenditure do not include cash payments for savings or land restitution of which the combined amount is around LTL 5 billion (10.5 percent of 2001 GDP), as they could not be afforded in this framework. Some noncash compensations could take place or small payments could be made over a long period if other expenditures were cut.

<sup>6</sup> The cost of EU accession is reflected in cofinancing for investment and other projects (around 0.3 percent of GDP, depending on the implementation rate) under the three programs—SAPARD, ISPA, and PHARE—under the relevant expenditure categories and guaranteed borrowing for 2001-03. EU grants which are allocated under the above mentioned programs have an upper limit of around €130 million in 1999 prices (1.1 percent of GDP), and the actual amount of grants depends on the available amount of cofinancing. The financing of government's commitments under the *Acquis Communautaire* during the post accession period would be facilitated by membership grants from the EU. This scenario draws on the preliminary quantification of Lithuania's contributions to the EU and prospective grants for 2003-04, which is presented in a joint study of independent experts financed by the EU and the Ministry of Finance ("Support for Policy Impact

(continued)

floor for expenditure on education of 7 percent of GDP.<sup>8</sup> Given all these considerations, the proposed tax reform would increase revenue by 0.3 percent of GDP, provided EU grants are included as revenue and the impact of a diversion of 1 percent of GDP of the payroll tax to the mandatory privately funded pension scheme is excluded.

10. The staff recommended that a number of tax measures be implemented in a gradual manner, because of uncertainties related to the impact of tax measures, expenditure restructuring, and pension reform on the consumption/saving behavior of households and investment decisions of corporations, as well as growth. These uncertainties would possibly imply wide margins of error in the projections of tax bases. A gradualist approach would leave the government enough flexibility to react to unexpected developments and adapt policies if needed. The scenario recommended by the staff is based on such principles. All CIT exemptions and deductions would be abolished while accelerated depreciation would be introduced for some assets, and the rate would be reduced from 24 percent to 23 percent in 2002. Excises on cigarettes, selected petroleum products, and beer would be gradually increased. Excises on remaining nonexcisable goods in the EU would be abolished in 2002. Special levies on previously excisable goods would be introduced in 2002. VAT exemptions would be abolished and selected reduced rates would be increased to 18 percent in 2002. The personal income tax rate would be decreased from 33 percent to 30 percent in 2003, and 29 percent from 2005 onwards. The tax exempt minimum would be gradually increased to LTL 250 on October 1, 2001, LTL 290 in 2003, LTL 305 in 2004, and LTL 320 in 2005. The taxation of author's rights would be revised. The gross sale tax, financing the road fund, would be abolished in 2004. A car property tax would be introduced in 2003, generating 0.1 percent of GDP. Taxes on pollution would be increased in 2004 and trade taxes would be revised in accordance with EU requirements. A municipal real estate tax for individuals would be introduced in 2003.

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Analysis/Budgetary Impact"). The closure of the Ignalina power plant is assumed to begin in 2005 for which the required financing has been earmarked by the EU.

<sup>7</sup> The cost of NATO accession is incorporated in the binding floor on defense expenditure of 2 percent of GDP, which was achieved already in 2001.

<sup>8</sup> A Seimas resolution establishes a floor on national budget expenditure on education at 7 percent.

Vilnius  
July 26, 2001

Mr. Horst Köhler  
Managing Director  
International Monetary Fund  
Washington, DC 20431

Dear Mr. Köhler:

1. The overarching objective of Lithuania's economic policies is to promote sustained economic growth and improved living standards through continued macroeconomic stability and further implementation of structural reforms necessary for an efficiently functioning of market economy and enhancement of competitiveness. Early accession to the EU and NATO is our main policy goal. The key elements of our economic policy strategy will be to maintain the currency board arrangement as the cornerstone of macroeconomic stability; to further fiscal consolidation in order to support external viability; and to advance the remaining key structural reforms at a fast pace. The attached Memorandum of Economic Policies (MEP) lays out the concrete policy measures to be taken during July 1, 2001-December 31, 2002.

2. In support of the policies detailed in the MEP, we request approval of a 19-month stand-by arrangement with the International Monetary Fund (IMF), in an amount equivalent to SDR 86.52 million. We do not envisage at this time making purchases under the arrangement, but could do so if economic circumstances were to be worse than expected. We understand that the Fund will monitor the program on the basis of quarterly performance criteria, and three reviews will be conducted, as laid out in the MEP.

3. We believe that the policies described in the MEP are adequate to achieve the objectives of the program, but will stand ready to take additional measures as necessary to achieve those objectives. During the period of the arrangement we will consult with the IMF on the adoption of any such measures that may be appropriate, in line with the Fund's policies on such consultations.

4. We are committed to transparency in our economic policies, and we authorize the Fund to publish this letter and the MEP following Executive Board approval of the program.

Yours sincerely,

//s//  
Algirdas Brazauskas  
Prime Minister

//s//  
Reinoldijus Šarkinas  
Chairman of the Board  
Bank of Lithuania

Attachment: Memorandum of Economic Policies

REPUBLIC OF LITHUANIA

MEMORANDUM OF ECONOMIC POLICIES OF THE GOVERNMENT AND

BANK OF LITHUANIA FOR THE PERIOD

JULY 1, 2001–DECEMBER 31, 2002

I. INTRODUCTION

1. **During the past eighteen months, Lithuania has made significant progress in restoring macroeconomic stability**, following severe disruptions in 1998-99 in the wake of the Russian financial crisis. Decisive steps were undertaken with the support of a stand-by arrangement with the IMF, treated as precautionary, including the reduction of the general government fiscal deficit from 8.5 percent of GDP in 1999 to 2.8 percent in 2000, with a deficit of 1.4 percent of GDP planned for 2001. Exports grew by more than 25 percent in 2000, strongly outpacing the recovery of imports, so that the current account deficit declined from 11.2 percent of GDP in 1999 to 6.0 percent in 2000. Growth resumed in 2000, with real GDP increasing by 3.3 percent, as compared with a decline of 3.9 percent in 1999, and inflation remained subdued, with the average consumer price index (CPI) increasing by 1 percent on an annual basis. All of these positive developments boosted confidence in the Lithuanian economy and its currency board arrangement (CBA), allowing for continued access to international capital markets at increasingly favorable rates.

2. **Substantial progress was made during 2000 and the first half of 2001 in implementing structural reforms, essential to an efficiently functioning market economy**, with the support of a Structural Adjustment Loan (SAL) from the World Bank. Particularly important steps included: an initiation of the pension reform and strengthening of the finances of the state Social Insurance Fund (SoDra); significant fiscal structural reforms, including passage of the Organic Budget Law and steps to set up a Reserve Stabilization Fund (RSF) for the investment of privatization proceeds; important reforms of the Treasury system; a strengthening of the finances of Lithuanian Power (LPC) and Lithuanian Gas (LG) in advance of their future privatization; a rationalization of agricultural subsidies and support programs; passage of new bankruptcy and company restructuring laws, as well as amendments to the labor code to render the labor market more flexible; and a major breakthrough in privatization efforts, with the sale of an additional 25 percent stake in Lithuanian Telecoms via a public offering in June 2000, and of the Savings Bank and the Lithuanian Shipping Company (LISCO) in the first half of 2001 to major foreign investors via competitive tenders. At the same time, trade was liberalized further, with the accession to the WTO ratified in April 2001, while major progress towards European Union (EU) accession was registered.

3. **In spite of this progress, some areas of weakness remain.** Registered unemployment increased from 10.0 percent at end-1999 to 12.1 percent in June 2001, and social safety nets need to be reinforced. Further improvements to the business environment

and greater labor market flexibility are needed, in order to promote higher rates of growth, domestic and foreign investment, output, and employment creation. In fact, investment slumped from 26.5 percent of GDP in 1997 to just over 20 percent of GDP in 2000, and credit growth was sluggish during much of 2000. Insufficient progress was made in restructuring the electricity and gas sectors, leading to delays in privatization. Expenditure arrears of the central government, which amounted to LTL 440 million at end-1999, were reduced to LTL 19 million by end-March 2001, but not fully eliminated as targeted under the previous stand-by arrangement, while municipal arrears increased. Improvements in health and education are needed, and the finances of municipalities and the Health Insurance Fund (HIF) should be strengthened.

## II. THE GOVERNMENT'S PROGRAM FOR 2001-02

### A. Objectives and Strategy

4. **The new program aims at maintaining macroeconomic stability, strengthening external viability, and accelerating second-generation structural reforms.** These efforts will place Lithuania in a strong position to achieve early accession to the EU and contribute over time to higher, more sustainable growth, greater employment opportunities, higher incomes, and increased welfare for the Lithuanian population, as well as pave the way for a smooth repegging of the litas from the dollar to the euro. To achieve these goals, the government and Bank of Lithuania (BoL) intend to follow a three-pronged strategy of:

(i) **maintaining the currency board arrangement as the cornerstone of macroeconomic stability.** In this context, the BoL is preparing for the switch of the anchor currency from the dollar to the euro on February 2, 2002, in response to the increasing economic integration with the EU area;

(ii) **continuing the fiscal consolidation effort, aiming to achieve a credible budget deficit reduction path,** which is necessary to support the CBA and maintain external viability. Fiscal policy will also take into account the government's plans for rationalizing the tax structure, as well as the need to face a number of new expenditure obligations, fund the pension reform, stabilize municipal finances, and restructure expenditure on health and education. The target of achieving a balanced budget at the time of EU accession would contribute to assure medium-term external sustainability;

(iii) **advancing the remaining key structural reforms at a fast pace, in order to boost productivity and competitiveness, and underpin fiscal consolidation.** The government is determined to promote timely passage of the necessary legislation, and aims at quickly establishing a track record of successful implementation in all areas, thus strengthening the capacity of the economy to withstand increased competition and reap the full benefits of EU accession. In this regard, efforts will focus on addressing remaining fiscal structural weaknesses; continuing financial sector reform; improving the business environment; enhancing labor market flexibility; and completing the privatization program.

## B. Macroeconomic Outlook

5. **The macroeconomic outlook for 2001-02 envisages a continued recovery of growth, low inflation, and the maintenance of the external current account deficit at a sustainable level.** Economic growth is projected to accelerate from about 3.6 percent in 2001 to 4.7 percent in 2002, underpinned by a recovery of domestic demand and continued good export performance. Average inflation is projected at around 1 percent in 2001 and 3 percent in 2002. The external current account deficit is projected to widen slightly to 6.7 percent of GDP in 2001, reflecting the pick-up of domestic demand from 2001, and to start to narrow again in 2002, due to sustained export growth, enhanced productivity, a more business-oriented regulatory environment and a deepening of structural reforms. Foreign direct investment is projected to increase significantly in 2001-02, as several major privatization projects are to be completed during these years. Access to capital markets on favorable terms is expected to continue, and external debt ratios would remain stable.

6. **Over the medium term, macroeconomic policies will aim at boosting real growth rates to about 5-6 percent a year, maintaining inflation at around 2-3 percent, consistent with faster productivity growth than in trading partners, and gradually reducing the external current account deficit to below 6 percent of GDP by 2005.** This projected path would be underpinned by further fiscal consolidation, reaching a balanced budget position (excluding the cost of the pension reform) at the time of EU accession, assumed to occur in 2004, as well as further improvement in Lithuania's external competitiveness, brought about by structural reforms. A sizable share of EU-related investment would be financed by EU transfers, and about half of the external current account deficit would be financed by FDI inflows, contributing to a gradual reduction of external indebtedness and a strengthening of Lithuania's external position.

## C. The Currency Board Arrangement

7. **The CBA will continue to anchor macroeconomic policies.** This arrangement provides a stable monetary environment, contributing to maintaining low inflation and bolstering confidence. In response to increased economic integration with the EU area, and as a necessary step toward the eventual participation in the Exchange Rate Mechanism (ERM) from the time of EU accession, the BoL and the government intend to switch the anchor currency from the dollar to the euro at the market rate of the day in early 2002, while maintaining the CBA. On June 28, 2001, the BoL announced that the date of the repegging will be February 2, 2002, and it will take place at the reference exchange rate of the U.S. dollar and euro announced by the European Central Bank (ECB) on February 1, 2002. The announcement was made seven months in advance, in order to give adequate time to the population and enterprises to prepare for the switch. The BoL has discussed technical aspects of the repegging with the IMF and the ECB.

8. **Continued monetization is envisaged during the program period, owing to the strong confidence in the CBA.** Greater competition in the banking system, together with improved domestic business opportunities, would facilitate a revival in credit to the private



sector. Moreover, to help ensure monetary restraint, the program envisages limited reliance on privatization proceeds for budgetary financing. Further developments of monetary policy instruments are planned with a view to approaching ECB requirements. Over the medium term, the BoL envisages a gradual harmonization of minimum reserve requirement standards with those of the ECB. No reductions in required reserves are being envisaged at this time (Table 1). Treasury accounts were shifted from commercial banks to the BoL on June 30, 2001. The Treasury and the BoL will work closely to improve forecasts of cash flows, and coordinate these flows. The BoL will work to strengthen the functioning of the interbank and foreign exchange markets in order to ensure smooth and effective liquidity management. To safeguard monetary restraint, the program features performance criteria on the net foreign exchange coverage under the currency board arrangement and on minimum required bank reserves.

#### **D. Fiscal Policy and Fiscal Structural Reforms**

9. **The government's efforts to build on the fiscal consolidation achieved so far will remain at the center of the program in 2001-02.** Continued fiscal adjustment will boost the credibility of the CBA and lead to further reductions in borrowing costs for the public and private sectors. Higher savings generated by the general government will also make significant contributions to national savings, liberating resources for investment and strengthening the external position. The accelerating economic recovery and concomitant strengthening of private sector demand should facilitate the task of deficit reduction. Tax reforms must be consistent with the pace of the targeted deficit reduction, taking into account the need to accommodate new expenditure commitments while maintaining an adequate level of social expenditures. The objective of achieving a balanced budget (excluding the cost of pension reform) at the time of EU accession, assumed in 2004, when the economy could be growing at its potential, would help assure medium-term external sustainability.

10. **The government intends to introduce changes in the tax system,** with the aim of easing the tax burden to promote employment-generating growth and investment, eliminating loopholes to make the system transparent, and implementing municipal taxes to strengthen municipal finances. The first phase of the tax reform will mainly focus on the corporate income tax (CIT), personal income tax (PIT), and consumption taxes. Tax reform measures after 2002 will include further steps in reforming consumption taxes, in accordance with EU requirements, and extending the coverage of the real estate tax. A further reduction in the PIT could be considered depending on progress in establishing the administrative capacity of municipalities to levy taxes and the overall strengthening of municipal finances. Reforms of the tax system will be complemented by improvements in tax administration (paragraph 18).

11. **On the expenditure side, there are a number of priorities and new commitments that must be faced:** the costs of EU and NATO accession, the legal commitments to finance education, the closure of the Ignalina nuclear power station, environmental remediation, pension reform, improvements to social expenditure, and clearance of remaining expenditure arrears. The savings and land restitution programs represent additional substantial obligations that could only be fulfilled over a long period of time, given other pressing expenditure

needs; hence, cash payments on their account will be limited to about 0.1 percent of GDP in 2001-02. The public investment program will be geared towards infrastructure, environmental and other projects necessary for EU accession, and further improvements in education. After a period of strong adjustment and deep expenditure cuts, there is little immediate scope for further reductions if essential services and social expenditures are to remain adequate; however, the government will pursue expenditure rationalization and seek gains in efficiency across the board.

12. **The fiscal deficit target for 2001 of 1.4 percent of GDP remains appropriate.** In July, Seimas adopted the Law on Amendment to the Law on Approval of Financial Indicators of the State Budget and the Budgets of Municipalities for 2001 of the Republic of Lithuania, by which the national budget (the state budget and municipal budgets) was adjusted. The revised law aims at reallocating expenditure while keeping the budget deficit target unchanged. The revision increases both revenue and expenditure by LTL 80.3 million (0.17 percent of GDP). In the event that revenue shortfalls were to emerge later in the year, the government is committed to take necessary measures to ensure that the budget deficit target is achieved. The financing of the general government deficit remains as initially budgeted. Privatization proceeds of 2.7 percent of GDP will be largely deposited outside commercial banks. Net foreign financing will amount to 0.8 percent of GDP, with the largest part—the February eurobond proceeds equivalent to 1.5 percent of GDP—already having been disbursed. Net domestic financing of -2.1 percent of GDP will reflect mainly the build-up of government deposits. The modest general government deficit and a strict limit on guaranteed debt will lead to a modest increase in public and publicly guaranteed debt from 29 percent of GDP in 2000 to 29.6 percent in 2001. The government will make its best effort to refrain from providing guarantees for the investment projects of Mazeikiu Nafta, which could be required by the privatization agreement.

13. **The 2002 budget will incorporate the first phase of the tax reform, and reflect further expenditure consolidation, while making room for new expenditure demands.** General government revenue is estimated to decline by around 1.5 percent of GDP due to slow growth of the tax bases of the payroll tax, PIT, and excises (0.8 percent of GDP), a decline in nontax revenue of 0.2 percent of GDP, and the net negative impact of the first phase of the tax reform of around 0.5 percent of GDP. Tax reforms will continue in 2002 when the government plans to implement a package including the following elements: (i) from January 1, 2002, an increase of the tax exempt minimum (TEM) of the PIT from LTL 214 to LTL 250; ii) a reduction of the CIT rate from 24 percent to 23 percent, alignment of the CIT with EU requirements, elimination of most exemptions and tax breaks, and introduction of accelerated depreciation for some cases (basically in total revenue neutral changes); (iii) a realignment of consumption taxes with a view to bringing them in line with EU requirements, including the elimination of certain VAT exemptions (+0.1 percent of GDP), a reduction in the turnover tax (-0.2 percent of GDP), a change in excise collection procedures (-0.2 percent of GDP), and an increase in excises on diesel fuel which will be offset by exemptions granted to farmers; (iv) some of the excise taxes incompatible with EU requirements will be converted into specific taxes (revenue neutral); and (v) a reinstatement of the capital gains tax. In addition, the government will introduce changes to the tax system

to improve transparency and eliminate loopholes. Finally, the government will avoid any broadening of the coverage of the lump-sum taxes on specific professional activities (patents) that would entail revenue losses as a result of substitution from higher-yielding taxes.

14. **The government will seek ways to reduce the overall expenditure to meet the deficit target, mainly through expenditure rationalization at the level of the state budget.** A budget deficit target of about 1.3 percent of GDP would be consistent with continued progress in external adjustment. In the event the tax reform package will be substantially different from the one described in paragraph 13, the necessary expenditure adjustments would be made to reach this deficit target. For the program to remain credible, these adjustments will have to be kept realistic and feasible. The composition of expenditure restructuring and a more precise quantification of EU accession costs will be discussed with the IMF staff in the context of the first program review. The deficit could be financed comfortably from domestic and external sources.

15. **The efforts to strengthen municipal finances will focus on defining more clearly the functions of municipalities, strengthening expenditure management, and finding new sources of revenue.** These measures would help address the structural causes of municipal expenditure arrears, thereby helping clear outstanding arrears by end-2002 and preventing their reemergence. A special government commission has been established to define local governments functions, including those mandated by the central government, and their financing sources. A set of comprehensive measures to overhaul municipal finances will be prepared by the time of the completion of the first program review (December 2001). The Law on amendment of the Law on the Methodology of Establishment of Revenues of Municipal Budget, which will establish more precise and adequate principles for balancing revenues of municipal budgets with regard to the implementation of state mandated functions and the procedure for allocating funds, will be submitted to Seimas by end-September 2001. Furthermore, the Cabinet-level commission on expenditure arrears will continue its monthly monitoring of the clearance of municipal arrears. The State Control will be asked to conduct a performance audit of municipalities and to provide recommendations on how to resolve the problem of expenditure arrears. In this context, municipalities which incur arrears due to insufficient administrative capacity and weakness in expenditure management will be provided with technical assistance. Legislation giving municipalities more discretion in setting tax rates and fees accruing to local budgets—including a real estate tax of up to 1.5 percent of assessed property values—will be submitted to Seimas by end-December 2001. This would lead to greater predictability in revenue and flexibility in the financial management of municipalities. In addition, the central government will not undertake any unconditional bail-outs: any financial transfers to municipalities to clear expenditure arrears will be part of a comprehensive financial restructuring plan. Transfers from the central government to municipalities earmarked for arrears clearance will be made in separate tranches; with each tranche conditional on the fulfillment of scheduled plans for the reduction in the outstanding stock of arrears. The reduction of municipal arrears will be monitored via a structural benchmark under the program. Moreover, greater transparency will be introduced with quarterly publication of municipal financial statements, additional audits of municipalities with increasing arrears, and possible sanctions. As a general

principle, the general government will strictly refrain from recourse to mutual debt cancellation or other netting or offset schemes, including with suppliers and tax payers.

16. **The finances of the Health Insurance Fund (HIF) will also be strengthened.** The HIF will submit to the government proposed changes to procedures for pricing and classifying medical services and financial management of public health care institutions with assistance from the World Bank by December 2001. The government will also adopt a plan for streamlining the procedures for marketing and reimbursement of pharmaceuticals. In this regard, the HIF will submit to the government a revision to the list of pharmaceuticals subject to reimbursement by end-October 2001. Finally, three-year budgetary estimates of the HIF will be prepared by a joint committee including representatives from the Ministry of Health, Ministry of Finance, Prime Minister Office, and the Ministry of Social Protection by December 2001. The first program review will focus on the appropriate strategy ensuring medium-term sustainability of the HIF to be submitted to Seimas with the 2002 budget.

17. **A pension reform introducing a three-pillar pension system will start in 2003 comprising:** (i) a pay-as-you go pillar; (ii) a mandatory contribution-defined second pillar financed by a diversion of at least 5 percentage points of the payroll tax for the younger cohorts of the population, with the middle age group to have an option to participate in the second pillar; and (iii) a voluntary, privately-funded pillar. As soon as Seimas has passed the reform of the pension system, the government will submit to Seimas a draft law authorizing private pension funds to manage the accumulated resources under the second pillar and a draft amendment to the current Law on Social Security. The government plans to finance the transition cost of the pension reform, currently estimated at about 1 percent of GDP per year for the first three years of operation, partly by privatization proceeds. To help finance the transition to the new pension system, an amendment to the Privatization Law setting up the Reserve Stabilization Fund (RSF) in line with the recommendations of the July 2000 technical assistance mission of the Fiscal Affairs Department of the IMF will be submitted to Seimas by end-September 2001. This amendment will authorize the government to set up the RSF for accumulating privatization proceeds and use the accumulated proceeds to finance the pension reform. The regulations of the RSF will be approved by the government by end-November 2001. These regulations will include provisions on: (i) major principle of asset management and audit procedures; (ii) Seimas approval of the annual budget of the RSF in the context of the approval of the national budget; and (iii) a requirement to publish annual reports and results of the audit of the RSF. The government is committed to maintain the improved financial position of SoDra and to take steps to reduce pensions paid directly by the state budget.

18. **The government will further modernize and strengthen its tax administration and general administrative capacity.** Amendments to the Law on Tax Administration were submitted to Seimas in April 2001. The draft revises the system of penalties, tax arrears write-offs and deferrals. The Ministry of Finance will resubmit to the government a draft law merging the payroll tax collection function of SoDra with the State Tax Inspectorate. A new draft of the law on merging the State Tax Inspectorate with the payroll tax collection of SoDra will be resubmitted to Seimas. In addition, the Ministry of Finance has established two

new departments, strengthening its administrative capacity to manage and monitor grants and co-financing of EU-related projects. In this regard, estimates of EU grants and the needed cofinancing will be included in the 2002 draft budget. To avoid the accumulation of expenditure arrears of the state budget, the Treasury will improve the control over expenditure commitments of appropriation managers on a monthly basis. Moreover, to ensure effective management of the state financial resources, specialists of the Ministry of Finance and the BoL will implement joint measures for the forecasting and management of these resources.

19. **The government intends to request from the IMF a Report on the Observance of Standards and Codes (ROSC) on fiscal transparency.** This report will assess fiscal transparency practices in Lithuania in respect to the requirements of the IMF Code of Good Practices on Fiscal Transparency—Declaration of Principles. The government will review the current practices in the areas needing improvement, as identified by the report.

#### **E. Other Structural Policies**

20. **The government is committed to continue to implement measures to improve further the business environment,** which is key for enhancing the investment climate and attracting foreign direct investment. Following the recommendations of the sunset and sunrise commissions, the market regulation system has been streamlined with the centralization of business inspection functions in two main agencies, and the sunset commission has assumed formally the function of monitoring administrative barriers. Future steps in the government's program include the streamlining of registration and liquidation procedures for companies through amendments to the current law by September 2001; the passage by Seimas by end-2001 of legal amendments that will put in place national accounting standards compatible with EU regulations; formal training for administrators and judges on new bankruptcy procedures; preparation of a manual on bankruptcy and restructuring procedures by mid-2002; and the simplification of the restitution of land ownership rights by October 2001.

21. **The government is committed to continue with its program to rationalize government agricultural programs and financial support to agriculture, with a view to EU accession.** Considerable progress was made in 2000 to reduce government subsidies via price supports that led to overproduction. These efforts will continue in 2001-2002 in line with commitments to the WTO and World Bank. Through greater oversight and accountability, the government will aim to reduce the losses of the Agricultural and Food Products Market Regulation Agency (AFMRA) stemming from market support, procurement and storage operations, which diverts scarce resources from rural development programs, rural infrastructure and EU cofinancing. As such, the government will facilitate the implementation of EU SAPARD programs, including with measures to ensure greater cofinancing possibilities in rural areas. The Ministry of Agriculture will continue its information campaign on the modalities of cofinancing of SAPARD grants by the private sector, provide training to farmers, and collaborate with commercial banks.

22. **A number of measures will be taken to increase labor market flexibility,** including implementation of flexible forms of employment and remuneration, as well as short-term and training contracts. To codify the existing system of regulation, the Unemployment Insurance Law and Labor Code will be submitted to Seimas in 2001. In addition, the government will continue its commitment to targeted job training programs that are defined by the projected demand in the private sector. Moreover, the social safety net will be reinforced by better targeting of social assistance, so as to protect the unemployed, especially the long-term unemployed and least advantaged segments of the population, thus contributing to social cohesion and support for the reform process.

23. **The privatization program is to be substantially completed in 2001-02,** leading to enhanced efficiency and promoting the overall restructuring of the economy. The privatizations for the Savings Bank and LISCO were completed; the buyers pledged to invest an additional LTL 150 million in the Savings Bank over the next two years and US\$60 million in LISCO during the next three and a half years. The cargo business of LISCO, which was not sold during the privatization, will be offered for sale in a new tender to be organized by end-June 2002. A tender for advisory services in the privatization of the Lithuanian Airlines will be completed by October 1, 2001, with the company to be restructured and prepared for privatization by end-2001. The sale of Lithuanian Airlines is expected to be completed by April 2002. A reorganization of Lithuanian Railways (LRR) will continue according to the plan approved by the government on May 3, 2001, with attention to be given to the separation of freight and passenger services from infrastructure, clarification of the structure of management with a view to improving the financial position, and implementation of a public service obligation concept. Reorganization of the railways is a complex task that will require considerable efforts, and the government plans to privatize LRR by end-2003. The government will also continue efforts to privatize small and medium business and land plots, as well as small residual shareholdings (less than one-third government stake) in some 1,200 companies.

24. **In the energy sector, the restructuring and privatization of Lithuanian Power Company (LPC) and Lithuanian Gas (LG) will continue during 2001-02.** Amendments to the Law on Restructuring LPC passed by Seimas in June 2001. Registration of LPC successor companies is expected to be completed by the end of 2001. Distribution and generation companies will be offered for sale by end-February 2002—a condition under the World Bank SAL for the distribution companies—with closing of privatization transactions targeted for end-June 2002. The government will make every effort to enforce claims on Belarus for electricity deliveries, as well as monitor new export arrangements to ensure that no new arrears are incurred. For LG, the company will be offered for sale in the second half of 2001, and closing of the privatization targeted for end-2001. In all of these privatization efforts, the government remains committed to ensuring transparency in the privatization process, including by the retention of international advisors and conducting the sales according to open, international tenders.

25. **Financial sector reforms will focus on the completion of bank privatization, strengthening of the supervision of financial institutions, and further improvements in**

**legislation to promote a deepening of financial intermediation.** The privatization of the Agricultural Bank (LZUB) remains a high priority. A tender for new privatization advisors was concluded in May. It is expected that a new LZUB privatization tender will be announced by end-September 2001. If the Swedish parent companies of Vilnius Bank and Hansabank, the new owner of the Savings Bank, complete a merger, one of the banks would be required to be divested so as to prevent excessive concentration of the banking system. A joint IMF-World Bank financial sector assessment (FSAP) mission is expected in the second half of 2001, in order to review the functioning, legal basis and stability of Lithuania's financial sector. The recommendations of this assessment mission will provide guidance for further steps to improve banking supervision and financial sector efficiency. In order to complete the appropriate legal framework for well-functioning financial markets, the Securities Insurance Law, in line with EU requirements, gradually increasing the protection for each investor up to €20,000 by 2008, and the General Financial Institutions Law have been submitted for Seimas' approval. The amendment to the Commercial Banking Law to speed up liquidation of banks undergoing bankruptcy proceedings has already been passed. The amendment to the Pension Fund Law which liberalizes the conditions for the establishment of the voluntary third pillar, and the Insurance Law in line with EU requirements which establishes similar standards for foreign and local entities have also been passed. Deeper financial intermediation will be promoted by improvements to legislation concerning collateral, repo transactions, and other financial instruments. In addition, the government will promote harmonized taxation of the full range of financial instruments.

### **III. PHASING, PERFORMANCE CRITERIA, BENCHMARKS, AND REVIEWS**

26. **The program will be monitored on the basis of quarterly quantitative performance criteria and indicative benchmarks, a set of structural policy benchmarks, and three reviews by the IMF Executive Board.** Quarterly quantitative performance criteria and benchmarks, consistent with the economic policy targets described above, have been proposed for the currency board arrangement, fiscal policy, and external debt management (Tables 1 and 2). The performance criteria relating to the currency board arrangement are designed to ensure its maintenance. The quantitative performance criteria and benchmarks relating to the general government budget aim to ensure that the fiscal stance is appropriately tightened as intended, domestic loan guarantee activities limited, and general government budgetary arrears cleared. The quantitative performance criteria on external debt have been determined with a view to safeguarding prudent external debt management and scaling back government guarantees for non-government borrowing. The definitions of all quantitative targets are provided in the Technical Memorandum of Understanding (Annex I). The structural policy benchmarks focus on actions considered particularly important for supporting the targeted budget adjustment and other key structural policy actions (Table 3). The SBA contemplates access of SDR 86.52 million with a possibility of seven equal purchases, the first one is conditional on approval of the arrangement by the IMF Board, and the remaining six are linked to the quarterly test dates and the completion of the reviews.

27. **The quantitative targets for end-September 2001 and end-December 2001 are performance criteria** (except for the indicative targets on domestic guarantees and central government arrears, which are benchmarks), while the targets for end-March 2002 and end-June 2002 are indicative targets. Performance criteria, benchmarks for domestic guarantees and central government arrears, and structural benchmarks for end-March 2002 and end-June 2002 will be set at the time of the first review. A quantitative benchmark for the reduction of municipal arrears will be introduced at the time of the first review, following preparation of a set of measures for strengthening municipal finances.

28. **The first program review will be based on end-September 2001 outcomes and is expected to be completed by end-December 2001.** The review will focus mainly on the 2002 budget, municipal finance reform, and progress in privatization. The second review will be based on end-March 2002 outcomes and is expected to be completed by end-June 2002.



Table 1. Lithuania: Performance Criteria for Stand-By Arrangement, 2001-02 1/

	Target	Adjusted Target	Outcome 2/
<b>Continuous performance criteria</b>			
I. Exchange rate			
LTL 4 per US\$1 3/	...	...	Observed through end-June
II. 100-percent coverage of currency board liabilities, in percent			
	100	...	Observed through end-June
III. Reserve requirements, in percent 4/			
	6	...	Observed through end-June
IV. Non-accumulation of new external payments arrears			
	...	...	Observed through end-May
<b>Quantitative performance criteria</b>			
I. Ceiling on the general government deficit, mln. LTL			
Cumulative from January 1, 2001			
March 31, 2001 (previous arrangement)	271	287	97
June 30, 2001	460	...	...
September 30, 2001	600	...	...
December 31, 2001	679	...	...
Cumulative from January 1, 2002			
March 31, 2002	232	...	...
June 30, 2002	420	...	...
II. Floors on net foreign exchange coverage of the currency board arrangement, mln. US\$			
Stocks			
March 31, 2001 (previous arrangement)	-127	...	-39
June 30, 2001	-127	...	-31
September 30, 2001	-127	...	...
December 31, 2001	-127	...	...
March 31, 2002	-127	...	...
June 30, 2002	-127	...	...
III. Ceilings on contracted public and publicly guaranteed medium- and long-term external debt; mln. US\$			
	All maturities	1-5 year maturity (medium- and long-term)	All maturities 1-5 year maturity
Cumulative from January 1, 2001			
March 31, 2001 (previous arrangement)	293	200	183 0
June 30, 2001	433	200	...
September 30, 2001	648	200	...
December 31, 2001	683	200	...
Cumulative from January 1, 2002			
March 31, 2002	450	200	...
June 30, 2002	500	200	...
IV. Ceilings on the outstanding stock of public and publicly guaranteed short-term external debt; mln. US\$			
Maximum stock during the period			
March 31, 2001 (previous arrangement)	0	...	0
June 30, 2001	50	...	...
September 30, 2001	50	...	...
December 31, 2001	50	...	...
March 31, 2002	200	...	...
June 30, 2002	200	...	...

Source: Ministry of Finance; and Fund staff estimates.

1/ Definitions and exclusions are presented in the Technical Memorandum of Understanding.

Numbers for end-June 2001 are indicative targets, numbers for end-September 2001 and end-December 2001 are performance criteria, and numbers for end-March 2002 and end-June 2002 are indicative targets.

2/ Based on latest available data.

3/ This performance criterion will be modified at the time of the repegging.

4/ This is consistent with the required reserve ratio of 8 percent.

Table 2. Lithuania: Quantitative Benchmarks for Stand-By Arrangement, 2001-02

	Ceiling	Outcome
I. Domestic guarantees, mln. LTL		
Outstanding stock		
March 31, 2001 (previous arrangement)	319	217
September 30, 2001	314	...
December 31, 2001	312	...
March 31, 2002	305	...
June 30, 2002	300	...
II. Central government arrears, mln. LTL		
Outstanding stock		
March 31, 2001 (previous arrangement)	0	19
September 30, 2001	0	...
December 31, 2001	0	...
March 31, 2002	0	...
June 30, 2002	0	...

Source: Ministry of Finance; and Fund staff estimates.

Table 3. Lithuania: Structural Benchmarks for Stand-By Arrangement, 2001

Measure	Date
Submit to Seimas draft amendments to the Law on Revenue Redistribution of Municipalities	end-September
Submit to Seimas draft amendments to the Privatization Law for establishing the Reserve Stabilization Fund	end-September
Tender for privatizing the Agricultural Bank	end-September
Government's decision on a set of measures to overhaul municipal finances	end-December
Submit to Seimas draft amendments to the Law on Social Security needed for the pension reform	end-December
Submit to Seimas legal amendments on accounting standards	end-December
Submit to Seimas the draft unemployment insurance law and the proposed new labor code	end-December

Source: Ministry of Finance; and Fund staff estimates.

## REPUBLIC OF LITHUANIA

### TECHNICAL MEMORANDUM OF UNDERSTANDING FOR THE 2001/2002 STAND-BY ARRANGEMENT

1. This Memorandum defines variables that constitute quantitative performance criteria and benchmarks for the stand-by arrangement and sets out the reporting requirements for the government and the Bank of Lithuania.

#### I. PERFORMANCE CRITERIA ON THE OPERATION OF THE CURRENCY BOARD ARRANGEMENT

##### **Maintenance of exchange rate under currency arrangement**

2. The present exchange rate of LTL 4 per \$1 will be maintained throughout the period of the program. The currency of the peg will be changed at the time of the repegging. In this connection, all performance criteria related to the currency board arrangement will be adjusted accordingly at the time of the repegging.

##### **Cover for currency board arrangement**

3. The Bank of Lithuania will ensure the maintenance of not less than 100 percent foreign reserve backing for the Bank of Lithuania's liabilities, as defined in paragraph 4 below under the currency board arrangement for the duration of the stand-by arrangement.

4. Foreign reserves backing will consist of the gross foreign reserves of the Bank of Lithuania, as defined in paragraph 10, expressed in Litai at the official exchange rates of the Bank of Lithuania. The Bank of Lithuania's Litai liabilities under the currency board arrangement comprise:

- (i) Litas notes and coins in circulation
- (ii) correspondent accounts of and certificates of deposit and other Litas liabilities to commercial banks and nonbank financial institutions;
- (iii) government deposits;
- (iv) staff and other private sector deposits;
- (v) correspondent accounts of foreign central banks.

### **Required reserves of the banking system**

5. Average reserve deposits of the banking system over each required reserve holding period established by the Bank of Lithuania (running from the 13<sup>th</sup> of one month to the 12<sup>th</sup> of the next month) shall not be permitted to be below required reserve deposits of the banking system, as defined in paragraph 6, by more than 2 percentage points of eligible liabilities, as defined in paragraph 6.

6. All banks will be required to hold reserve deposits on account with the Bank of Lithuania of not less than 8 percent of their domestic and foreign currency deposit liabilities. Together, these shall constitute the required reserve deposits of the banking system. The deposit aggregates against which required reserves of the banking system shall be calculated will be referred to as "eligible liabilities," as defined in the 28. December 1993 Resolution No. 52 of the Board of the Bank of Lithuania ("On Confirmation of the Rules for Required Reserves for Commercial Banks"). Average reserve deposits of the banking system for each reserve maintenance period will be calculated at the end of each holding period as a percentage of eligible commercial bank liabilities.

7. The Bank of Lithuania will extend new credits to banks only and in amounts that do not violate (i) the performance criterion requiring full foreign currency backing for currency board liabilities or (ii) the performance criterion specifying the minimum targets for net international reserves."

### **Performance criterion on floor on net foreign exchange coverage of the currency board arrangement**

8. International reserve assets and liabilities shall be valued in U.S. dollars using the Bank of Lithuania's official rates prevailing at each test date. For the period of the program, monetary gold will be valued at market prices according to BoL internal guidelines.

9. Net foreign exchange coverage of the currency board arrangement is defined as:  
(i) gross foreign reserves of the Bank of Lithuania, less foreign reserve liabilities;

less

(i) foreign currency-denominated liabilities of the Bank of Lithuania to domestic residents and privatization proceeds of the government held in the Bank of Lithuania; and

(ii) Litai liabilities of the Bank of Lithuania, as defined in paragraph 4, under the currency board arrangement, less deposits withdrawn through deposit auctions and any central bank bills.<sup>1</sup>

10. Gross foreign reserves of the Bank of Lithuania shall be defined as:

- (i) monetary gold holdings;
- (ii) holdings of SDRs;
- (iii) reserve position in the IMF; and
- (iv) holdings of foreign exchange in convertible currencies by the Bank of Lithuania.

11. Excluded from gross foreign reserves are:

- (i) capital subscriptions to foreign financial institutions;
- (ii) long-term nonfinancial assets of the Bank of Lithuania;
- (iii) convertible currency-denominated claims on domestic banks;
- (iv) assets in nonconvertible currencies; and
- (v) foreign assets pledged as collateral or otherwise encumbered.

12. Fund staff will be informed of details of any gold sales, purchases, or swap and derivative operations during the program period, and any resulting changes in the level of gross foreign reserves that arise from revaluation of gold carried out according to the accounting practice of the Bank of Lithuania will be excluded from gross reserves as measured herein.

13. Foreign currency-denominated reserve liabilities of the Bank of Lithuania shall be defined as:

- (i) the Bank of Lithuania's convertible foreign currency liabilities to nonresidents, with an original maturity of up to and including one year;
- (ii) the outstanding use of Fund credit.

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<sup>1</sup> The Single Treasury System will remain outside the Bank of Lithuania during the program period.

14. Excluded from foreign reserve liabilities are any liabilities arising from balance of payments support loans of maturity longer than one year, including such loans from the EU, the BIS or other international financial institutions, foreign governments or foreign banks.

15. Foreign currency-denominated liabilities to domestic residents shall include convertible currency deposits of the general government, and liabilities to banks and non-bank financial institutions, including deposits under the reserve requirement. Bank of Lithuania Litai liabilities under the currency board arrangement are defined in paragraph 4.

## **II. PERFORMANCE CRITERIA ON GENERAL GOVERNMENT FISCAL BALANCE, GUARANTEES FOR DOMESTIC BORROWING, AND ARREARS**

16. The general government encompasses the national government (comprising the state and municipal governments) and the extrabudgetary funds. The extrabudgetary funds include the Social Insurance Fund (SoDra), Health Insurance Fund, Privatization Fund, Road Fund, Ignalina Closure and Decommissioning Fund, and any other extra-budgetary operations. The central government is defined as the general government excluding municipalities.

17. The general government deficit is determined on a cash basis.

- The overall deficit is the excess of total expenditure plus net lending over total revenue and grants. For the purpose of program monitoring, it is defined as the negative sum of (i) net domestic financing; (ii) net external financing and (iii) net privatization receipts (Table 1).
- Net external financing is the sum in national currency of (i) the disbursements of external loans (to the entities covered above the line or on-lent by the general government, including but not limited to budgetary organization and appropriation managers); (ii) exceptional financing (rescheduled principal plus interest if any); (iii) proceeds from bonds or other debt-related instruments issued abroad; less: (iv) amortization due (including but not limited to amortization payments of appropriation managers and budgetary organizations); and (v) changes in assets held for liquidity and/ or investment purposes outside the domestic banking system.
- Net domestic financing is the sum of net bank financing and net nonbank financing.
  - Net bank financing is defined as the change in the banking system's claims on the general government in domestic and foreign currency, including the change in the holdings of government securities by the banking system; minus the change in balances held in the central bank and the commercial banks and other banking institutions.

- Net nonbank domestic financing is defined as the sum of: (i) the change in the holdings of government securities by nonbanks, calculated as the difference between the change in the stock of government securities and the change in the holdings of government securities by the banking system; (ii) any net direct borrowing from nonbank institutions, including by budgetary organization and appropriation managers.
- Net privatization proceeds are defined as the cash receipts from asset sales by the general government from abroad or domestically minus privatization-related expenditure. Expenditures necessary for, and directly related to, the privatization of state-owned enterprises shall be deducted from gross privatization proceeds and will not be classified as expenditure above the line in the fiscal accounts. These are limited to (i) outlays for consultants and advisers, (ii) increases in authorized capital prior to the sale of an enterprise, and (iii) outlays due to assuming the clean-up of environmental damages as identified in specific privatization agreements.

18. The ceiling on the general government deficit is subject to two adjusters: for faster-than-projected implementation of net lending operations and for faster-than-projected implementation of investment projects by budgetary organizations and appropriation managers.

19. For the purpose of assessing the observance of the ceilings on the general government fiscal balance, the program targets will be adjusted upwards by the amount actually disbursed and on-lent under already committed foreign loans from International Financial Institutions (including the World Bank, the EBRD, the EIB, and the NIB) and other sources of financing as specified in Table 2 are higher than the amounts assumed under the program with a 50 percent implementation rate of the total annual commitment.

20. The implementation of general government investment projects carried out by budgetary organizations and appropriation managers, including but not limited to the Ministry of Defense, is specified in Table 3 on a quarterly institution-by-institution basis. The performance criterion on the fiscal deficit will be adjusted by the amount equal to the excess of the actual appropriations over the programmed cumulative quarterly amount for every project, assuming a 50 percent implementation rate of the total annual commitment. The adjusted amount for every project for each test date shall not exceed the annual appropriation for each project based on a 100 percent implementation rate.

21. General government guarantees on domestic borrowing include all guarantee commitments for (i) borrowing in domestic currency from residents and nonresidents and (ii) borrowing in foreign currency issued for the Agricultural Marketing Agency and the Export and Import Credit Insurance Agency (Table 4).



22. Outstanding payment obligations of the general government include all identified obligations incurred by the state government, municipalities, SoDra, the Health Insurance Fund, and other extrabudgetary funds as covered by the definition of general government provided above. Outstanding payment obligations are defined as delayed payments for deliveries of goods and services when a bill has been received but not paid after 45 days. For wages and salaries, and pensions, outstanding payment obligations are defined to exist when payments are delayed by more than 7 days. Outstanding payments obligations of the central government are defined as outstanding payments obligations of the general government minus outstanding payments obligations of the municipalities outside the general government (Table 5).

### III. PERFORMANCE CRITERIA ON EXTERNAL DEBT

**Ceiling on contracting or guaranteeing of external debt (i.e., debt denominated in foreign currency) with original maturities of more than one year by the public sector with a sub-ceiling on external debt with original maturities of longer than one year and including five years.**

23. For purposes of this performance criterion, the public sector comprises: (i) general government (as defined in paragraph 16), (ii) the Bank of Lithuania, and (iii) other agencies on behalf of the general government (Table 6). This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted by the Executive Board on August 24, 2000 (Decision No. 12274-(00/85) but also to commitments contracted or guaranteed for which value has not been received. Excluded from the limits are use of IMF resources, guarantees of foreign currency-denominated borrowing of the Agricultural Marketing Agency and the Export and Import Credit Insurance Agency covered in paragraph 21, and foreign currency direct borrowing and guarantee by the municipalities from resident banks which are not guaranteed by the central government. Included are other than IMF balance of payments support from official creditors.

**Ceiling on the outstanding stock of external debt (i.e., debt denominated in foreign currency) with original maturities of up to and including one year owed or guaranteed by the public sector.**

24. For purposes of this performance criterion, the public sector excludes the Bank of Lithuania. The term debt has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000 by the Executive Board (Decision No. 12274-(00/85). Excluded are normal import-related credits, liabilities on the correspondent accounts with central banks of the BRO (Baltics, Russia, and other countries of the former Soviet Union) countries, guarantees of foreign currency-denominated borrowing of the Agricultural Marketing Agency and the Export and Import Credit Insurance Agency covered under paragraph 21, and foreign currency direct borrowing and guarantee by the municipalities from resident banks which are not guaranteed by the central government.

25. The general government will not accumulate external payments arrears on any expenditure item or external debt as defined paragraph 23-24. Transactions subject to the ceilings specified in Section III shall be valued in the contracted currency and converted into U.S. dollars at the time the loan agreement is entered into at the exchange rate for the end of the month.

#### IV. REPORTING

26. The authorities will provide the IMF with information needed to monitor the implementation of the program on a regular basis and in accordance with the timetable indicated below. Fund staff will review together with the authorities the data reporting on an ongoing basis and revise the reporting whenever necessary.

##### **Information on money and banking**

27. *On a monthly basis*, the Bank of Lithuania will provide information on:

- international reserves;
- the balance sheet of the Bank of Lithuania, deposit money banks, other banking institutions, and the consolidated banking survey;
- the structure of bank assets and liabilities;
- the currency exchange between the Bank of Lithuania, commercial banks, and the general government.

28. In line with SDDS requirements, the data on international reserves of the Bank of Lithuania will be provided to the Fund on the 7<sup>th</sup> day after the end of the month at the latest; the balance sheet of the Bank of Lithuania will be provided to the Fund on the 14<sup>th</sup> day after the end of the month at the latest throughout the program period in the agreed format. The other data referred to in paragraph 28 will be provided to the Fund on the 24<sup>th</sup> day after the end of each month at the latest throughout the program period in the agreed format.

##### **General government budget implementation and financing**

29. *On a monthly basis*, the Ministry of Finance will provide information on:

- below the line financing of the consolidated general government;
- revenue of the national government (state government and municipalities);
- on-lending operations of the general government to the nongovernment sector;

- revenue and expenditure of all extrabudgetary funds included in the calculation of the general government financial balance;
- outstanding domestic government debt broken down by maturity and type of debt (direct and guaranteed), including disbursements and redemption;
- domestic debt service;
- use of resources borrowed abroad;
- general government deposits held abroad;
- disbursements and repayments of foreign loans;
- borrowing by municipal governments;
- domestic guarantees issued during the month and the stock of outstanding domestic guarantees at the end of the month (Table 3); and
- the stock of outstanding payment obligations of the general government, broken down by state government, municipalities, the Social Insurance Fund, the Health Insurance Fund, and each of the other extrabudgetary funds (Table 4).<sup>2</sup>

30. These data will be reported to the Fund within 30 days after the end of each month throughout the program period in the agreed format.

31. *On a quarterly basis*, the Ministry of Finance will provide information on:

- state government revenues and expenditures in terms of both economic and functional classification; and
- local government revenues and expenditures in terms of both economic and functional classification.

32. For the state government, these data will be reported to the Fund within 30 days after the end of the quarter throughout the program period in the agreed format. Data for municipalities will be reported to the Fund within 90 days after the end of the quarter throughout the program period in the agreed format.

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<sup>2</sup> Outstanding payment obligations of municipalities will be reported on a quarterly basis.

### Information on the External Sector

33. *On an monthly basis*, the Ministry of Finance and the Bank of Lithuania will provide information on:<sup>3</sup>

- short-term and long-term external debt stock of the public and private sector<sup>4</sup> including non-concessional loans from multilateral organizations; and
- external debt service for short-term and long-term external debt of the public sector.

34. These data will be reported to the Fund within 30 days after the end of each month throughout the program period in the agreed format.

35. The above reporting requirements will be assessed on an ongoing basis, and may be revised at the initiative of the Fund and with the consent of the government and the Bank of Lithuania.

June 26, 2001

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Mr. M. Jonikas  
Vice Minister of Finance  
Ministry of Finance

//s//

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Mr. A. Kregzde  
Vice Governor  
Bank of Lithuania

<sup>3</sup> The Ministry of Finance will provide data on public debt and the Bank of Lithuania will report data on private debt.

<sup>4</sup> Information on registered private sector loans will be provided on a monthly basis, actual figures for the external debt stock of the private sector will be reported on a quarterly basis.

Table 1. Lithuania: General Government Financing, 2000-1

	2000	2000	2000	2000	2001
	Q1	Q2	Q3	Q4	Q1
Stocks, millions of litai (end of period)					
Domestic credit to government					
1 Short term loans & advances to central government (DMBs)	41.5	41.5	7.6	8.0	0.0
2 Long term loans & advances to central government (DMBs)	121.6	118.0	135.0	95.6	126.7
3 Claims on municipal governments (DMBs)	214.2	203.1	239.4	273.5	271.8
4 Claims on social insurance fund (DMBs)	231.6	243.4	234.6	267.6	281.6
5 Savings bonds	75.6	87.3	113.8	130.1	149.4
6 Recapitalization bonds	634.0	634.0	634.0	514.2	514.2
7 Treasury Bills (at issue value)	1,220.3	1,327.1	1,463.0	1,549.0	1,573.5
7.1 Held by DMBs	524.4	611.4	556.2	494.9	515.5
7.2 Held by OBLs	18.7	23.1	28.1	31.2	29.7
7.3 Held by Nonbanks	677.2	692.6	878.7	1,022.9	1,028.3
8 Total adjusted credit to government (sum of lines 1-8)	2,538.7	2,654.4	2,827.4	2,838.0	2,917.2
Government deposits					
9 Central government deposits (BOL)	927.9	1,246.9	994.4	781.7	832.7
10 Central government deposits (DMBs)	672.6	723.4	906.3	576.7	807.0
11 Central government deposits (OBLs)	132.7	104.6	105.6	105.6	110.7
12 Municipal government deposits (DMBs)	108.0	119.6	194.9	135.8	115.0
13 Privatization funds (DMBs)	225.3	174.6	151.9	149.2	219.8
14 Social insurance fund (DMBs)	26.2	30.1	35.8	58.4	39.0
15 General government deposits (sum of lines 9-14)	2,092.8	2,399.2	2,388.9	1,807.4	2,124.2
Flows, in millions of litai					
16 Changes in domestic credit (change in line 8)	210.6	115.7	173.0	10.6	79.2
17 Changes in domestic deposits (change in line 15)	-717.2	-306.4	10.3	581.5	-316.8
18 Float between government deposits noncaptured through monetary accounts	0.0	0.0	0.0	-73.5	73.5
19 Domestic repayments to nonbanks	0.0	-43.5	0.0	-22.5	0.0
20 Net domestic Financing (sum of lines 16-19)	-506.6	-234.2	183.3	496.1	-164.1
21 Foreign Borrowing	992.4	61.3	535.4	35.7	760.8
22 Amortization by the central budget	41.0	127.0	571.1	220.3	41.5
23 Amortization by appropriation managers	23.5	61.1	23.0	55.7	20.0
24 Change in the government deposit abroad	0.0	0.0	0.0	0.0	526.7
25 Net flows of funds from abroad (line 21-line 22-line 23-line 24)	927.9	-126.8	-58.7	-240.3	172.6
26 Net privatization proceeds	45.6	602.0	72.4	83.3	88.9
27 General government fiscal balance (line 20+line 25+line 26)	466.9	241.0	197.0	339.1	97.4
28 Cumulative fiscal deficit	466.9	707.9	904.9	1,244.0	97.4

Sources: Ministry of Finance; and staff estimates.

Table 2. Lithuania: Investment Projects from On-Lent Resources, 2001-02

Nr.	Creditor	Reg. Nr.	2001				2002	
			year	Q1	Q2	Q3	Q4	year
<b>I. Nonbudgetary organizations</b>								
1	World Bank (Lithuanian Energy)	0019	28,000	8,970	6,500	6,500	6,030	14,388
2	World Bank (Klaipėda Water)	0020	12,480	0	4,160	4,160	4,160	0
3	World Bank (Šiauliai Water)	0032	840	0	840	0	0	0
4	World Bank (CJSC "Geoterma")	0033	6,300	2,126	4,174	0	0	0
5	World Bank (The Housing Credit Foundation)	0034	10,700	4,650	6,050	0	0	0
6	World Bank (Agriculture Sector)	0035	6,000	520	1,500	1,500	2,480	0
7	European Investment Bank (Lithuanian Railways)	0046.1	26,440	8,963	17,477	0	0	0
8	European Investment Bank (Lithuanian Railways)	0046.2	12,904	0	0	6,452	6,452	54,782
9	NIB (municipality 20 mln. EUR)	0052	73,442	736	24,311	24,311	24,084	0
10	European Investment Bank (municipality 15 mln. EUR)	0059	6,940	0	0	3,470	3,470	23,840
11	European Investment Bank (Panevėžio municipality - 6 mln. EUR)	0060	1,000	0	0	500	500	7,000
12	World Bank (municipality - 18,89 mln.EUR)	0066	31,120	0	15,050	0	16,070	14,000
13	World Bank (energy saving project - 8 mln. USD)	...	2,000	0	0	0	2,000	12,000
	Total (1-13)		218,166	25,965	80,062	46,893	65,246	126,010
<b>II. Budgetary organizations</b>								
1	World Bank (Ministry of Social Security and Labor)	0042	4,661	0	1,550	1,550	1,561	1,260
2	Europe Social Development Fund (Ministry of Social Security and Labor)	0043	1,000	0	0	0	1,000	6,000
3	Europe Social Development Fund (Ministry of Social Security and Labor)	0058	5,459	0	1,700	1,900	1,859	0
4	World Bank (health project -21 mln. USD)	0069	20,000	0	6,500	6,500	7,000	27,040
5	World Bank (education project - 25 mln. USD)	...	2,000	0	0	2,000	0	10,000
6.1	Soc. Development fund (School renovation project - 2,5 mln. USD)	...	10,000	0	0	10,000	0	0
6.1	Soc. Development fund (School renovation project - 2,5 mln. USD)	...	10,000	0	10,000	0	0	0
6.1	Soc. Development fund (School renovation project - 2,5 mln. USD)	...	10,000	0	10,000	0	0	0
6. II	GS( High school renovation project)	...	2,000	0	0	2,000	0	0
7	GS Courts	...	2,000	0	0	2,000	0	0
8	GS Ministry of health	...	29,000	0	29,000	0	0	0
9	GS Ministry of internal affairs	...	10,884	0	0	5,884	5,000	0
10	GS Custom	...	6,830	0	6,830	0	0	0
	Total (1-10)		101,834	0	55,580	29,834	16,420	44,300
	Total (I-II)		320,000	25,965	135,642	76,727	81,666	170,310

Source: Ministry of Finance.

Table 3. Lithuania: State Budget Expenditures on Investment Projects Financed from Borrowed Resources, 2001  
(In millions of Litai)

	2001				
	Year	Q1	Q2	Q3	Q4
Total	229.75	51.94	73.94	51.94	51.94
Ministries	162.01	35.00	57.00	35.00	35.00
Ministry of National Defense	75.76	13.44	35.44	13.44	13.44
Ministry of Culture	8.32	2.08	2.08	2.08	2.08
Ministry of Social Security and Labor	9.72	2.43	2.43	2.43	2.43
Ministry of Health	39.47	9.87	9.87	9.87	9.87
Ministry of Education and Science	28.75	7.19	7.19	7.19	7.19
Regions	40.00	10.00	10.00	10.00	10.00
Departments, Services, and Inspectorates	8.20	2.05	2.05	2.05	2.05
Department of Sciences and Studies under the Ministry of Education and Science	8.20	2.05	2.05	2.05	2.05
Enterprises and Organizations	0.37	0.09	0.09	0.09	0.09
Education, culture and other institutions and organizations	19.17	4.79	4.79	4.79	4.79
Science and studies	19.13	4.78	4.78	4.78	4.78
Public enterprises: translation, documentation and information center	0.04	0.01	0.01	0.01	0.01

Source: Ministry of Finance.

Table 4. Lithuania: Ceilings on Stock of General Government Guarantees for Domestic Borrowing, 2000-02  
(In millions of Litai)

	2000							2001				2002		
	Q1	Limit	Q2	Limit	Q3	Limit	Q4	Limit	Q1	Limit	Act.	Q2	Q3	Q4
Total	565	547	499	527	451	487	489	489	489	376	315	314	312	305
Special agencies	252	290	228	290	243	270	283	270	178	255	252	250	243	
Agricultural marketing agency	240	260	215	255	230	225	233	230	165	230	230	230	220	
<i>of which: SAPARD program cofinancing</i>	...	...	...	...	...	...	...	20	0	20	20	30	40	
Export and import credit insurance agency	11	30	13	35	12	45	50	40	14	25	22	20	23	
SoDra	177	177	175	177	175	177	177	177	159	...	...	...	...	
Other	136	80	95	60	33	40	29	42	39	60	62	62	62	

Source: Ministry of Finance.



Table 5. Lithuania: Stock of General Government Outstanding Payment Obligations, 1999-2001  
(In millions of Litai, unless otherwise indicated)

	1999		2000			2001
	Dec. 31	Apr. 1	Jul. 1	Oct. 1	Dec. 31	Apr. 1
Total outstanding payment obligations	594	470	443	317	236	264
(in percent of annual GDP)	1.4	1.1	1.0	0.7	...	...
State government	125	81	86	65	17	18
Wages and salaries	8	5	7	3	2	3
Other expenditure	118	77	80	62	15	15
Municipalities	155	233	237	183	195	245
Wages and salaries	14	21	11	7	10	12
Other expenditure	140	212	225	176	185	233
SoDra	0	0	0	0	0	0
Pensions, wages and salaries	0	0	0	0	0	0
Other expenditure	0	0	0	0	0	0
Health Insurance Fund	0	14	55	23	23	0
Payments to health care providers	0	0	0	0	0	0
Wages and salaries	0	0	0	0	0	0
Other expenditure	0	14	55	23	23	0
Privatization Fund	0	3	0	0	0	1
Wages and salaries	0	0	0	0	0	0
Other expenditures	0	3	0	0	0	1
Rural Support Fund	231	129	62	19	0	0
Wages and salaries	0	0	0	0	0	0
Other expenditure	231	129	62	19	0	0
Road Fund	83	10	4	28	2	0
Wages and salaries	0	0	0	0	0	0
Other expenditure	83	10	4	28	2	0
<i>Memorandum item:</i>						
Nominal GDP	42,649	44,530	44,530	44,930	44,930	47,028

Sources: Ministry of Finance; municipalities; and extrabudgetary funds.

Table 6. Lithuania: Newly Contracted Public and Publicly Guaranteed Debt, 2001-02

Name of the Project	Spending Agency	Source of Financing	Amount	
			in LTU mn.	in US\$ mn.
2001				
Q2				
Vilnius heating project	Ministry of Finance	World Bank	120	30
Lithuanian Rail Road, Kena project	Lithuanian Rail Road	...	10	3
Lithuanian Road Administration Agency	Road Fund	EIB and NIB	400	100
Q3				
Energy saving project	Ministry of Finance	World Bank	32	8
School renovation project	Ministry of Finance	SDF	10	3
Mazeikiu Nafta	Mazeikiu Nafta	...	472	118
Ministry of Defense projects	Ministry of Defense	...	90	23
Lithuanian Rail Road project	Lithuanian Rail Road	EBRD	216	54
Q4				
Education project	Ministry of Education	World Bank	100	25
2002				
Q1				
Bonds	Ministry of Finance	...	1,600	400
New projects	...	...	200	50

Source: Ministry of Finance.

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## **IMF Approves US\$111 Million Stand-By Arrangement for Lithuania**

The Executive Board of the International Monetary Fund (IMF) today approved a 19-month Stand-by Arrangement of SDR 86.5 million (about US\$111 million) for the Republic of Lithuania to support the government's economic program. The decision will enable Lithuania to draw SDR 12.4 million (about US\$16 million) from the IMF immediately. The authorities have indicated that they intend to treat the arrangement as precautionary.

The last arrangement with Lithuania, a 15-month stand-by credit of SDR 61.8 million (about US\$79 million), expired on June 7, 2001.

Following the Executive Board discussion on Lithuania, Shigemitsu Sugisaki, Deputy Managing Director and Acting Chairman, said:

"The Lithuanian authorities made remarkable progress in achieving their objectives under the program supported by the previous Stand-By Arrangement. Policies of fiscal tightening and structural reforms led to a resumption in growth, a sharp external current account adjustment, and renewed confidence in the currency board arrangement. However, unemployment remained high, and weakness in municipal finances persisted.

"Building on the considerable achievements so far, the new program aims to maintain macroeconomic stability, promote private sector activity, and strengthen external viability in order to attain sustainable growth and create employment opportunities. The authorities plan to achieve these objectives by maintaining the currency board arrangement—which has anchored macroeconomic adjustment—while continuing fiscal consolidation, and advancing remaining structural reforms.

"The cornerstone of the authorities' strategy continues to be fiscal restraint. The 2002 budget target strikes a balance between the need to maintain a prudent fiscal stance while leaving room for financing new expenditure priorities. Moreover, the authorities intend to simplify the tax structure and strengthen expenditure control and budget management, as well as reform municipal finances.

"The authorities are following an appropriate approach of preparing a medium-term fiscal framework, determining priorities, and seeking ways to achieve the medium-term goal of a balanced budget. In this context, the authorities' strategy to rationalize the tax structure while accommodating expenditure priorities, including the potential expenditures relating to EU and

NATO accessions and pension reform, would bolster confidence in the path of economic policies.

“The authorities have announced their plan to switch the peg of the litas from the U.S. dollar to the euro in early 2002, while maintaining the currency board arrangement. The switch is consistent with the progressive orientation of trade towards the euro area and greater economic integration with the region. In this regard, the authorities are committed to a transparent and carefully laid out repegging process.

“Progress in structural reforms including the completion of banking privatization and in the areas of energy and agriculture remain crucial. The authorities’ efforts to make the labor markets more flexible and efforts to create a more business-friendly environment will make Lithuania attractive for investment, which would lead to higher growth and employment,” Mr. Sugisaki said.

## **Program Summary**

Under the previous program supported by a stand-by credit, Lithuania achieved significant progress in macroeconomic stabilization and structural reforms, and greatly improved its prospects for EU membership in the first wave of expansion. All macroeconomic objectives under the previous program were attained. In 2000, GDP grew by 3.3 percent, mainly underpinned by export growth. In the first quarter of 2001, real GDP grew by 4.4 percent year-on-year, led by continued strong export growth and a pick up of domestic demand. Prices and wages increased modestly in the first months of 2001, and the unemployment rate started to fall in April for the first time in the last two years—declining for three consecutive months to 12.1 percent in June. The external current account deficit shrank sharply to 6 percent of GDP in 2000 from 11.2 percent in 1999, mainly reflecting strong export growth and the demand-containing effects of the fiscal deficit adjustment. The current account deficit was about 6.5 percent of GDP in the first quarter of 2001. On the fiscal front, after remarkable consolidation achieved in 2000, when the general government deficit was reduced to 2.8 percent of GDP from 8.5 percent of GDP in 1999, public finances continued to improve in the first quarter of 2001. The deficit for the first quarter of 2001 amounted to 0.9 percent of annual GDP (0.3 percent less than programmed). There continued to be improved confidence in the banking sector, with credit to the private sector starting to pick up in the first half of 2001, after having fallen in 2000.

The new program aims at maintaining macroeconomic stability, strengthening external viability, and facilitating private activity. Real GDP is expected to grow by 3.6 percent in 2001 and 4.7 percent in 2002, reflecting a recovery of domestic demand and continued good export performance. The pickup of domestic demand would lead to an increase in imports and a slight widening of the external account deficit in 2001 to 6.7 percent of GDP from 6 percent in 2000. Subsequently, the current account deficit would start to decline slightly again in 2002, due to sustained export growth, a more business-oriented regulatory environment, and a deepening in structural reforms.

The fiscal deficit for 2001 of 1.4 percent of GDP remains appropriate. The fiscal deficit target for 2002 is 1.3 percent of GDP. General government revenue is likely to decline in 2002, while expenditure will remain constant in real terms. In light of the lower revenue to GDP ratio, spending cuts and reallocation would be necessary. Financing needs in 2002 should be met comfortably, given a substantial lengthening of maturities and deepening of the domestic market for government securities, and access to international capital markets on favorable terms.

The program is based on a strategy of maintaining the currency board arrangement (CBA), and continuing fiscal consolidation effort, together with advancing the remaining key structural reforms. The currency board—the currency of the peg will be switched from the dollar to the euro on February 2, 2002—will continue to anchor macroeconomic policies, providing a stable monetary framework, helping to keep inflation low, and bolstering confidence. Continued monetization is expected during the program period, given the strong confidence in the CBA.

The government's medium-term objective of achieving a structural balanced budget by the time of EU accession, excluding the cost to the pension reform, will help boost the credibility of the CBA, contribute to a reduction in interest rate spreads, and underpin the projected current account deficit adjustment. The government sees the need for a comprehensive tax reform in the lead-up to EU accession and is working on a detailed plan.

Under the program, the government plans to continue structural reforms. In the fiscal sector measures will include addressing the structural causes of municipal expenditure arrears and implementing those that would eliminate these arrears, preparing legislation for the upcoming pension reform, and strengthening tax administration and improving administrative capacity and fiscal transparency. In the financial sector, the government will take additional steps to strengthen the banking system, and reduce government involvement further by privatizing the remaining state bank. Furthermore, the government will continue to improve the business climate ensuring an environment conducive to private activity and attracting foreign direct investment. The government will also continue to foster greater labor market flexibility.

The Republic of Lithuania joined the IMF on April 29, 1992. Its quota<sup>1</sup> is SDR 144.2 million (about US\$185 million). Its outstanding use of IMF credits totals SDR 131 million (about US\$168 million).

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<sup>1</sup> A member's quota in the IMF determines, in particular, the amount of its subscription, its voting weight, its access to IMF financing, and its allocation of SDRs.

Table 1. Lithuania: Selected Macroeconomic Indicators, 1998-2002

	1998	1999	2000	2001		2002
			Prel.	Prev. Proj.	Prog.	Proj.
<b>National income, prices, and wages</b>						
Nominal GDP (in millions of litai) 1/	42,990	42,655	44,930	47,400	47,012	50,509
GDP (in millions of U.S. dollars) 1/	10,748	10,664	11,232	11,850	11,753	12,627
Real GDP growth (year-on-year, in percent) 1/	5.1	-3.9	3.3	3.6	3.6	4.7
Average CPI (year-on-year change, in percent)	5.1	0.8	1.0	1.0	0.6	2.8
End-of-period CPI (year-on-year, in percent)	2.4	0.3	1.5	1.9	2.0	3.0
GDP deflator (year-on-year, in percent)	6.7	3.2	2.0	2.1	1.0	2.6
Average monthly wage (in U.S. dollars)	232	247	252	...	...	...
Unemployment rate (in percent) 2/	6.9	10.0	11.5	...	...	...
<b>Saving-investment balance (in percent of GDP)</b>						
Gross national saving	12.3	11.5	14.7	14.9	15.2	15.4
General government	-0.7	-4.0	-0.4	0.5	0.7	0.8
Non-government	13.0	15.4	15.1	14.5	14.6	14.6
Gross national investment	24.4	22.7	20.7	21.4	21.9	22.0
Foreign saving	12.1	11.2	6.0	6.5	6.7	6.6
<b>General government (in percent of GDP)</b>						
Financial balance	-4.4	-6.2	-2.1	-1.3	-1.3	-0.9
Net lending	1.5	2.4	0.7	0.1	0.1	0.4
Fiscal balance	-5.9	-8.5	-2.8	-1.4	-1.4	-1.3
<b>External sector</b>						
<b>Current account balance</b>						
in percent of GDP	-12.1	-11.2	-6.0	-6.5	-6.7	-6.6
in millions of U.S. dollars	-1,298	-1,194	-675	-771	-786	-836
Gross official reserves (in millions of U.S. dollars) 3/	1,460	1,242	1,376	1,668	1,790	1,986
External debt (in percent of GDP) 4/	34.8	42.5	43.2	43.2	44.8	44.5
Debt service (in percent of exports of GNFS)	18.3	20.0	20.9	13.3	13.5	16.4
Exchange rate (litai/euro, period average)	...	4.2	3.7	...	...	...
Real effective exchange rate (1995=100, "+"=appreciation) 5/	142	160	171	...	...	...
<b>Money and credit</b>						
Reserve money (year-on-year change, in percent)	28.8	-4.0	-3.0	0.2	2.0	4.4
Broad money (year-on-year change, in percent)	14.5	7.7	16.5	6.9	8.9	8.5
Private sector credit (year-on-year change, in percent) 6/	16.9	13.8	11.2	11.3	9.5	9.8
Money multiplier	2.0	2.2	2.6	2.8	2.8	2.9
Currency/deposits, in percent	50.7	43.9	34.1	32.5	32.5	31.6
Foreign currency deposits/ litai deposits, in percent	57.0	77.7	83.8	80.9	80.9	80.9

Sources: Lithuanian authorities; and IMF staff estimates and projections.

1/ GDP for 1999 has been substantially revised by the Statistical Office since EBS/00/28 has been published

2/ Registered unemployment, end-of-period.

3/ Including valuation changes. Gross official reserves reported here differ from the monetary survey because they include reverse repos involving major currencies in both legs.

4/ External liabilities minus equity investment in Lithuania.

5/ CPI-based, trade-weighted real exchange rate against 21 major trading partners in 1999.

6/ Dec. 2000 is adjusted for LTL 270 million of DMB's reclassified loans. If included, private sector credit would fall by 6.1 percent.

**Statement by Olli-Pekka Lehmussaari, Executive Director  
for the Republic of Lithuania  
August 30, 2001**

Let me start by thanking the staff on behalf of my authorities and myself for the well-balanced assessment of the challenges facing the Lithuanian economy. My authorities highly appreciate the extensive consultations with the staff and are delighted that the fruitful cooperation with the staff team has developed into a new economic program. They do not have any major disagreement with the staff appraisal.

Topping Lithuania's political and economic agenda, the EU accession has become one of the key driving forces behind the country's adjustment and reform efforts. Thanks to a significant economic advancement and firm policies, the country has progressed fast reorienting its economy toward the EU. The trade with the EU is growing steadily. In the first half of 2001 more than half of Lithuania's total export went to the EU countries. Presently more than  $\frac{3}{4}$  of Lithuania's total exports are exports to the EU and EU accession countries. By opening all negotiating chapters of the "acquis communautaire" and provisionally closing 18 of them, Lithuania has been successful in catching up with the first wave EU candidate countries. The government's ambitious goal is to complete the accession negotiations by 2002 and to assume obligations of the EU membership by January 2004. As of May 31, 2001, Lithuania became a member of the World Trade Organization.

The timetable for Lithuania's accession negotiations is tight and macroeconomic policy choices are challenging. A new precautionary stand-by program oriented towards achieving sustainable growth and creating greater employment opportunities will enhance stability and will serve as a basis for Pre-accession Economic Program that is to be submitted to the European Commission in the near future. My authorities would like to restate their determination to continue the prudent policy course aimed at getting ready for EU accession.

**Recent economic developments and outlook**

The year 2000 witnessed a recovery of the Lithuanian economy, with real GDP increasing by 3.3 percent, mainly supported by healthy export demand. In the first half of 2001, GDP growth reached 5.1 percent fuelled by exports and to some extent domestic demand. Growth was particularly strong in industries producing manufactured goods with high value added. Lithuania's export growth for the first half of this year was 25 percent and the industrial output growth measured in current prices was 16 percent. In addition, the external current account deficit narrowed from 11.2 percent of GDP in 1999 to 6.0 percent in 2000. The improvement in the external balance was supported by very rapid fiscal consolidation.

The unemployment rate approached 12.1 percent in June 2001, reflecting a typical problem of transition economies, caused by the rapid restructuring of the economy and



privatization. The government has been responding by improving further the business environment and pursuing greater labor market flexibility in order to promote higher rates of growth, investment and employment creation. These efforts include the implementation of flexible forms of employment and remuneration and creation of targeted job-training programs.

The Lithuanian authorities see the near-term economic outlook as broadly favorable. Economic growth is expected to accelerate from 3.6 percent in 2001 to 4.7 percent in 2002, while average inflation, which in 2000 was contained at 1.4 percent, is projected at around 1 percent in 2001 and 3 percent in 2002. Exports are expected to continue to grow while the current account deficit will remain at around 6-7% of GDP. The most recent indicators support the government's view that the economic outlook remains positive.

### **Fiscal policy**

The authorities continue their course of fiscal consolidation which will remain at the center of the economic program in 2001-2002. Over the program period the authorities have to accommodate substantial fiscal costs related to EU and NATO accession, and at the same time maintain a sustainable fiscal position over the medium term. To meet these goals, the government will pursue expenditure rationalization and improve the way to prioritize and manage public spending.

After cutting the general government deficit by 5.7 percentage points in 2000, the deficit will be further reduced to 1.4 percent of GDP in 2001 and 1.3 percent in 2002. The authorities' intention is to balance the general government's cyclically adjusted fiscal budget in the medium term.

The government sees room for improvements in the tax system by strengthening the municipal revenue base and their financial management, eliminating a number of loopholes in the existing tax system and harmonizing the tax system with EU requirements. The government will try to limit revenue losses stemming from the tax reform during 2001-02. The authorities intend to gradually reduce the personal income tax for lower-income groups while, at the same time, reducing exemptions to the corporate income tax and broadening the base of the property tax by eliminating loopholes in the tax system, thus compensating for the reduction of other taxes. New regulations on excises have already been approved by the government and submitted to the Parliament. New regulations regarding excises and VAT will be effective from July 1, 2002. New laws on property taxation will be introduced from January 1, 2003.

More importantly, the government is consolidating further the management of public funds, addressing the structural causes of municipal expenditure arrears by defining better municipal functions, strengthening expenditure management, improving statistical data collection and imposing greater transparency. To that end a special commission has been established to define clearly municipal functions and their

financing sources. Legislation, establishing more precise and adequate principles for balancing revenues of municipal budgets and giving municipalities more discretion in setting tax rates and fees accruing to local budget will be submitted to Seimas by the end of September 2001.

### **Exchange rates and monetary policies**

My Lithuanian authorities continue to see the currency board arrangement as the most suitable monetary framework at the current juncture. This framework has been tested by severe shocks and has successfully passed the test. In order to encourage further economic convergence and economic integration with the EU area, and to harmonize trade and competitive conditions with those existing in the EU and other accession countries, the decision to switch the anchor currency from the US dollar to the euro was taken by the Bank of Lithuania. The Parliament has passed the necessary legislative amendments and the government supported this important decision. The authorities consider the euro peg monetary arrangement as the appropriate framework in the run-up to Lithuania's joining the EMU.

In order to give adequate time for the population and enterprises to prepare for the switch, the Bank of Lithuania announced seven months in advance that as of February 2, 2002, the euro will be the anchor currency, and the official exchange rate of the litas will be established on the basis of the European Central Bank reference exchange rate of the euro and the US dollar from February 1, 2002. The announcement was well-received by the markets.

The authorities agree with the staff on the importance of a well functioning liquidity management system. The Bank of Lithuania started to publish daily liquidity data and improving coordination with the Treasury. Also the Bank is considering measures to improve functioning of the interbank market and the foreign exchange market.

### **Structural reforms and financial sector issues**

The pension reform is a centerpiece of the authorities structural reform agenda. The preparation for a three-pillar pension system, comprising as the first pillar the pay-as you go system with mandatory contributions, the second pillar with funded and mandatory contributions and, finally, the voluntary financed third pillar, is already underway. The cost of the pension reform, which will start in 2003, is estimated at about 1% of GDP for the 10-year transition period and will, to a large extent, be financed by privatization proceeds, placed into the Reserve Stabilization Fund. A law and government regulations will define the major principles of asset management and procedures, disclosure policy and requirement to be approved by Seimas in the context of the national budget. Eventually, the third pillar will promote savings and capital market development.

The privatization program is approaching completion, fostering the overall restructuring of the economy. The privatization of the Savings Bank and the Lithuanian Shipping Company LISCO has been completed. The authorities are also moving firmly to complete the privatization of the remaining large public enterprises. The tender for the advisory services in the privatization of the Lithuanian Airlines is under way and the government has approved a plan for reorganization of the Lithuanian Railways.

The amendments to the Law on Restructuring of the Lithuanian Power Company (LPC) were passed in June 2000. The privatization of the LPC is expected to be completed by mid-2002. A formal decision to privatize the Lithuanian Gas will be taken by September. At the same time a draft law regulating the power market is going to be drawn up by Seimas to regulate its effective functioning. The government is committed to ensure transparency of the privatization process by conducting the sales on the basis of open, international tenders.

Progress has been made in securing the conditions for further restructuring and increasing the market share of the oil refinery, by agreeing to sell 26.55 percent shares of Mazeikiu Nafta to the Russian company YUKOS, with a long-term guarantee of crude oil supply. The authorities are committed to reduce government intervention by further improving public administration and creating competitive business environment. The market regulation system was streamlined, and business inspection functions were centralized in two main agencies. The customs and transit procedures, building and construction regulations, land acquisition, procurement and other procedures, regulating the entrance into the market are to be reviewed by the Sunrise commission. New legal measures on bankruptcy became effective from mid 2001.

The restructuring of the Lithuanian banking sector has been completed. Banking supervision is effective and is close to full compliance with the Basle Core Principles for Effective Banking Supervision and relevant EU directives. In promoting further the financial sector reform, the authorities will privatize the last state owned Agricultural bank and improve the legal framework in line with the EU requirements. The Lithuanian authorities welcome the ongoing FSAP work that will be completed later this year.

Following the highest standards of transparency, the Lithuanian authorities welcome the publication of the staff report for the Lithuanian Request for a Stand-By Arrangement and the Letter of Intent, including the Memorandum of Economic Policies.