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Republic of Lithuania: 2003 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Lithuania

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with the Republic of Lithuania, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 13, 2003**, 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 July 28, 2003.** 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 staff supplement of **July 28, 2003** updating information on recent economic developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its September 5, 2003 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Republic of Lithuania.

The document(s) listed below have been or will be separately released.

Statistical Appendix

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

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for
the 2003 Consultation with the Republic of Lithuania

Approved by José Fajgenbaum and G. Russell Kincaid

July 28, 2003

- The 2003 Article IV discussions were held in Vilnius during June 3-13, 2003. The Fund team comprised Ms. P. Alonso-Gamo (head), Mr. R. Abdoun, Ms. S. Fabrizio, Mr. T. Rasmussen (all EU2), and Mr. I. Halikias (PDR), and was assisted by Ms. Z. Brixiova, the Fund's resident representative. Ms. J. Scarlata (MFD), participated in the mission to review implementation of FSAP recommendations. Mr. Andersen, Alternate Executive Director and Mr. S. Kropas, Advisor to the Executive Director, attended policy meetings.

- The mission met with Prime Minister Brazauskas, Bank of Lithuania (BoL) Governor Šarkinas, Minister of Finance Grybauskaite, Vice-Minister of Social Affairs Morkuniene, other senior government officials, the Seimas Budget Committee Chairman Butkevicius, parliamentarians, opposition parties, EU representatives, commercial bankers, the business community, church representatives, and academia.

- The Executive Board concluded on January 16, 2002, the 2001 Article IV consultation, and, on February 26, 2003, the third review under the Stand-By Arrangement that expired soon thereafter. No purchases were made. At the conclusion of the Article IV consultation, Directors praised Lithuania's strong economic performance, while acknowledging that it remained vulnerable to exogenous shocks. They stressed the importance of sound fiscal policies and, in light of increasing EU-related expenditures, emphasized the importance of careful expenditure prioritization. Directors endorsed the authorities' plan to switch the peg of the litas from the dollar to the euro, successfully implemented on February 2, 2002. They welcomed the authorities' participation in the Financial Sector Assessment Program (FSAP) and encouraged them to strengthen the banking system. Directors welcomed the significant acceleration in structural reforms and encouraged the authorities to persevere with further reforms, so as to maintain competitiveness and foster growth and employment.

- Lithuania has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions. The authorities have agreed to publish this staff report.

- Relations with the Fund and the World Bank are summarized in Appendixes I and II, respectively.

- In general, data are available on a timely basis and the staff has been given ready access to all available data. Official data for all sectors are of sufficiently good quality to support economic analysis. The periodicity and timeliness of most important statistics are presented in Appendix III. The ROSC fiscal transparency module and the ROSC data module were published in November 2002.

- As background for the Board discussion, the papers "Competitiveness in the Baltics in the Run-Up to EU Accession" (SM/03/118) and "Capital Markets and Financial Intermediation in the Baltic States" (SM/03/122) have been published.

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Lithuania: Basic Data

Social and demographic indicators (latest available data)	
Area (sq. km)	65,300
Population density (inhabitants per sq. km.)	53.0
Population (thousands)	3,475.6
Life expectancy at birth 1/	71.7
Men	65.9
Women	77.4
Infant mortality rate (per 1,000 births) 1/	8.0
Hospital beds (per 1,000 inhabitants) 1/	9.2
Physicians (per 1,000 inhabitants) 1/	4.0

	1998	1999	2000	2001	2002
	(In percent of GDP)				
National accounts					
Domestic demand	111.7	110.3	106.5	105.5	105.7
Consumption	85.4	87.2	86.3	84.5	83.0
Gross investment	26.3	23.1	20.2	21.0	22.6
External balance of goods and services	-11.7	-10.3	-6.5	-5.5	-5.7
GDP	100	100	100	100	100
	(Percentage change from previous period)				
Real GDP	7.3	-1.8	4.0	6.5	6.7
GDP (in millions of litai)	43,555	42,608	44,698	47,498	50,679
GDP per capita (in litai)	12,227	12,048	12,727	13,621	14,581
Consumer prices (end-period)	2.4	0.3	1.5	2.0	-1.0
Real wages 2/	13.7	5.4	-2.6	-0.2	5.0
Labor market					
Total employment (thousands) 3/	1,656	1,648	1,586	1,352	1,406
Of which: in state sector	528	512	486	453	423
Unemployment rate (in percent) 4/	6.4	8.4	11.5	12.5	11.3
	(In millions of U.S. dollars)				
Balance of payments					
Trade balance	-1,518	-1,405	-1,104	-1,108	-1,337
Current account balance	-1,298	-1,194	-675	-574	-734
	(Percentage change from previous period)				
Money and credit					
Broad money	14.5	7.7	16.5	21.4	16.9
Credit to private sector	16.9	13.8	-1.2	15.4	30.4
Interest rate (in percent per annum) 5/	12.0	13.0	11.9	9.3	6.6
	(In percent of GDP)				
General government finances 6/					
Revenue and grants	32.7	32.1	30.7	30.1	30.5
Expenditure and net lending	38.1	40.3	33.6	31.7	31.4
Financial balance 7/	-4.4	-6.2	-2.1	-1.8	-1.4
Fiscal balance 7/	-5.9	-8.5	-2.8	-2.0	-1.2

Sources: Lithuanian authorities; and Fund staff estimates.
1/ Data as of 2001.
2/ Average wage deflated by consumer price index.
3/ Figures for 2001 and 2002 reflect a downward revision of the estimated population.
4/ Calculated on the basis of registered unemployment; period average.
5/ Average annual interest rate on loans in domestic currency; period average.
6/ There is a break in series beginning in 1998 when a new classification of fiscal account was implemented.
7/ Including the discrepancy between monetary and fiscal data.

Executive Summary

Background: The Lithuanian economy is enjoying a remarkable economic expansion with very low inflation, despite the slowdown in Europe. Real GDP grew by 6.7 percent in 2002 and 9.4 percent in Q1 2003, driven by investment and exports. The current account deficit widened somewhat in 2002 to 5.3 percent of GDP, due to the fast growth of investment-related imports. Fiscal consolidation continued, with the budget deficit declining to 1.2 percent of GDP. Credit to the private sector expanded rapidly in response to low interest rates and increased economic activity. The unemployment rate declined to a four-year low of 9.4 percent in June 2003.

The discussions focused on the following issues relevant to macroeconomic stability:

- The medium-term outlook and external vulnerabilities, and the possible implications of prolonged economic weakness in Europe and an appreciating euro;
- The exchange rate and monetary framework before and after EU accession;
- Preserving the quality of bank's credit portfolios in a period of rapid credit expansion;
- The medium-term fiscal stance and the short-term need to accommodate EU-related costs;
- Structural reforms and the strengthening of the social safety net, to address high unemployment and regional inequalities.

The authorities and staff agreed that:

- The strategy to join the ERM II very soon after accession, maintaining an unilateral commitment to the CBA, and adopt the euro after two years of successful membership, subject to the agreement of the relevant EU authorities, constitutes a credible exit strategy, provided that domestic policies continue to be supportive and competitiveness appropriate.
- The rapid private sector credit expansion does not give rise to immediate concern given high-quality banking supervision, but will require continued monitoring. Overheating in the near term remains unlikely, but credit expansion or large capital inflows might fuel inflationary pressures in the future and threaten external viability.
- Maintaining low fiscal deficits in the short run and reaching a structurally balanced budget in the medium term are key to bolster the credibility of the CBA, safeguard the external position, and provide room of maneuver if countercyclical policies are needed.
- The widening of the fiscal deficit in 2003-04, due to the need to accommodate upfront expenditure related to EU membership, should not jeopardize macroeconomic stability, provided it remains limited and temporary. The fiscal deficit for 2003 needs to be kept as budgeted and for 2004 it should remain below 3 percent of GDP.
- There is a need to accelerate and deepen the structural reform process in order to sustain employment creation, rapid economic growth and preserve social support for the reforms.

The staff recommended that:

- At this stage in the cycle, the 2004 fiscal deficit should be limited to 2.6 percent of GDP, leaving a margin to meet the Maastricht criteria in the event of adverse developments.
- Given the tax revenue-to-GDP decline and the further possible losses in 2004 implied by EU requirements, alternative revenue sources are needed and tax exemptions should be eliminated.
- Further efforts should be made to strengthen administrative capacity in order to properly manage EU funds, given the potential scope for mismanagement and even corruption.
- The scope of the pension reform should be gradually expanded to ensure the long-term viability of the pension system, given the rapidly ageing population.

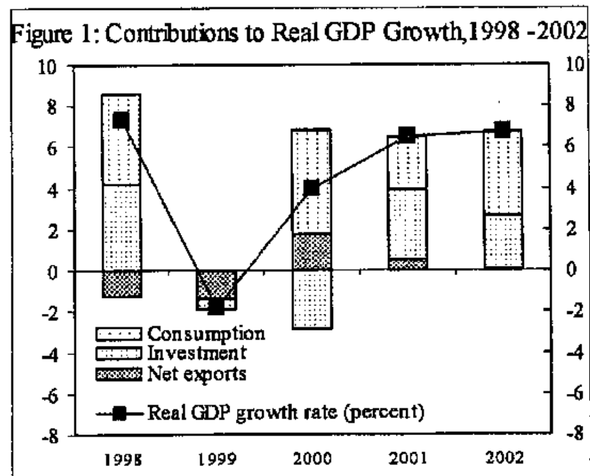
I. Introduction

1. **In the space of a few years, Lithuania has transformed its economy and is poised to join the EU in May 2004, after the favorable results of the referendum last May.** Lithuania's efforts since 2000, under two successive Stand-by arrangements (SBA), have left its economy well placed to rise to the challenges of EU accession. Prudent macroeconomic policies—in particular fiscal consolidation—and a significant breakthrough in structural reforms delivered macroeconomic stabilization, high growth, and low inflation; restored external viability and credibility; and placed the country in the first wave of EU accession. The policy discipline maintained to support the currency board arrangement (CBA) has contributed to macroeconomic stability, and its continuation will be key to ensuring a smooth and fast transition to the adoption of the euro. In 2003-04, a prudent fiscal stance, consistent with EU commitments, is required to bolster the CBA's credibility, attract FDI and reinforce sustainability. The increase in EU-related expenditures will make the maintenance of such a stance more challenging, however, and additional pressures may arise in connection with the October 2004 parliamentary elections. Structural reforms must be pursued in earnest to increase competitiveness, foster growth, and preserve social support for the reforms.

II. Recent Economic and Policy Developments

2. **The Lithuanian economy is enjoying a broad-based economic expansion with very low inflation.** Real GDP grew by 6.7 percent in 2002 and by 9.4 percent in the first quarter of 2003. Since the 1999 recession, economic growth has gradually become more balanced (Text Table 1, Table 1, and Figures 1-2). Supported by intense construction activity, investments continue to be a major source of growth, while consumption has gradually accelerated. This reflects higher household income following a gradual decline in unemployment and a pick-up in wage growth from close to zero in 2000-01 to about 5 percent during 2002. Exports continued to perform remarkably well in spite of the appreciation of the nominal effective exchange rate and the persistent softness of the EU economy, as the investments of recent years are loosening capacity constraints. The trade balance, however, remained broadly unchanged, as imports grew in step with exports. Inflation is virtually absent, with the CPI index falling by 0.9 percent in the 12 months to May 2003, reflecting cheaper imports and downward price pressures from increased competition and higher productivity. In these circumstances, wage growth slowed to 3.4 percent in the year to end-March 2003, and indications are that unit labor costs are falling even in the non-tradable sector. This was coupled with a further drop in the unemployment rate to a four-year low of 9.4 percent in June.

Figure 1: Contributions to Real GDP Growth,1998 -2002



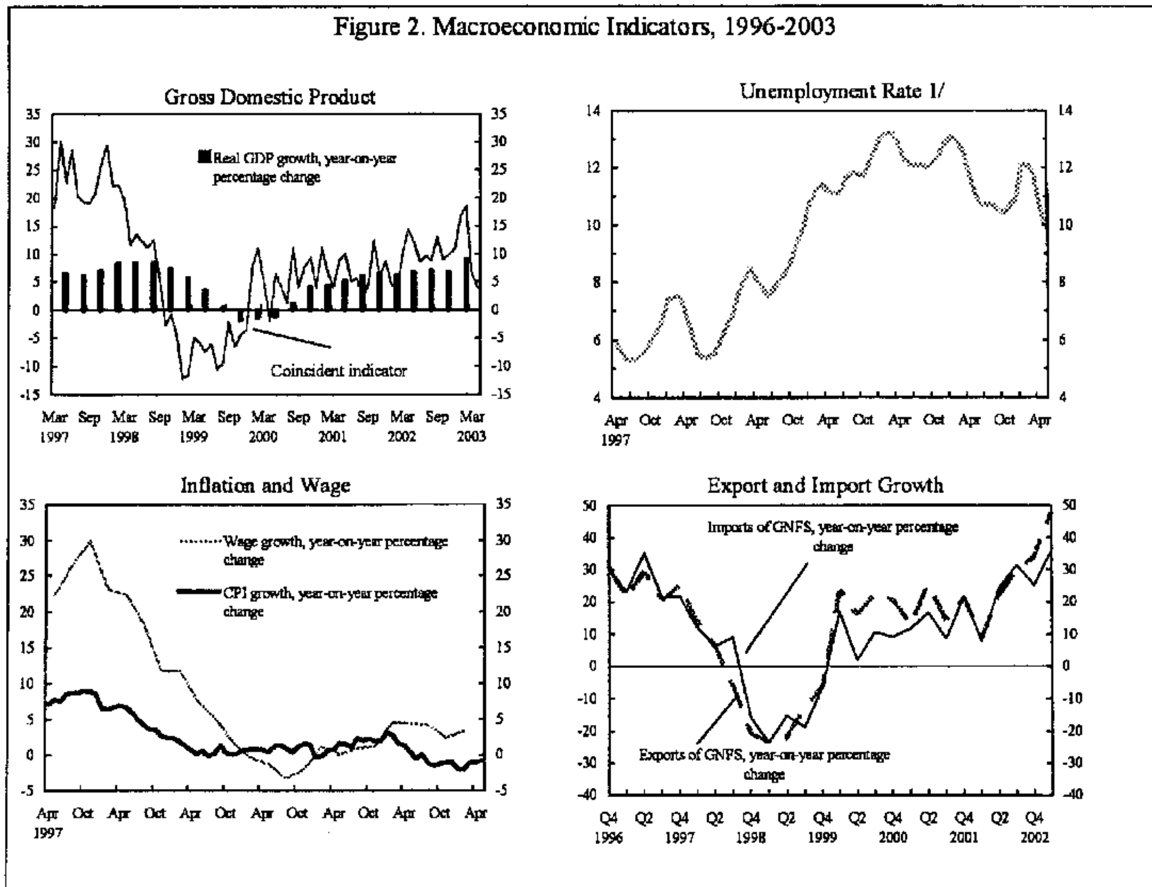


Figure 2. Macroeconomic Indicators, 1996-2003

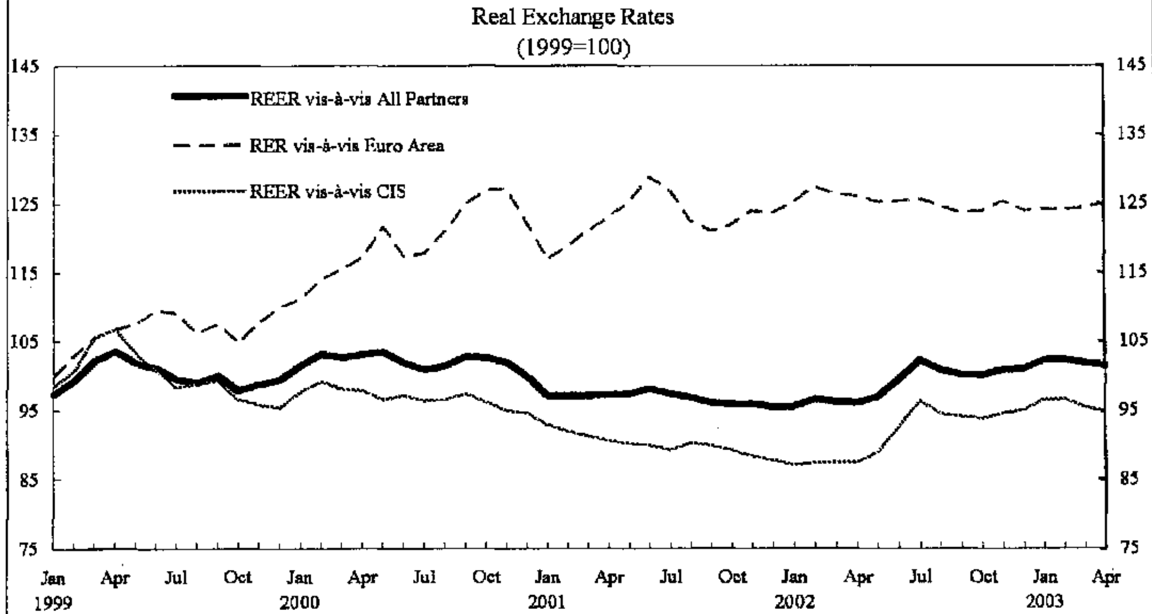
3. **Reflecting the litas' real appreciation and faster growth than in partner countries, the external current account deficit widened somewhat in 2002, to 5.3 percent of GDP from 4.8 percent in 2001** (Table 2) .This development does not raise competitiveness concerns so far, given the impressive export performance, with substantial gains in market shares (Figure 3). Also, the fast growth of imports was the result of strong private investment, with the share of capital goods in imports rising from 14 percent to 18.5 percent between 2001 and 2002. The current account deficit was easily financed by foreign direct investment (FDI). Net FDI grew by over 60 percent relative to 2001, reflecting ongoing privatization, as well as an expansion of operations by existing foreign investors and new investments induced by sound policies and the prospect of EU accession. Lithuania continued to tap international capital markets on increasingly favorable terms. Following the issue of a €400 million 10-year eurobond in May 2002, in February 2003, the government floated another €400 million 10-year eurobond at a record-low 74 basis points spread,

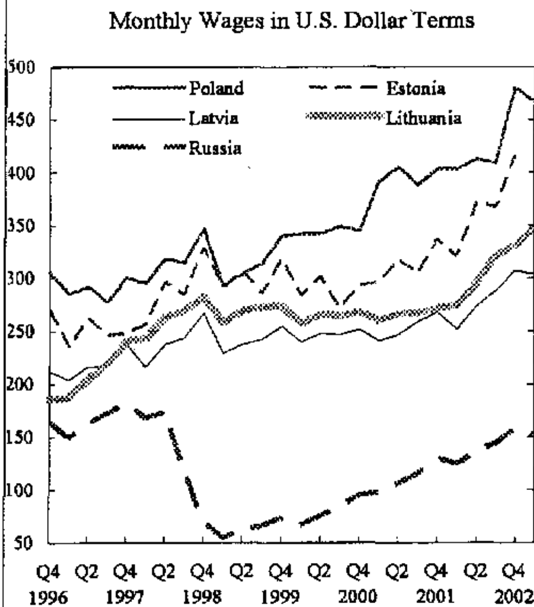
Text Table 1. Selected Macroeconomic Indicators, 1999-2003

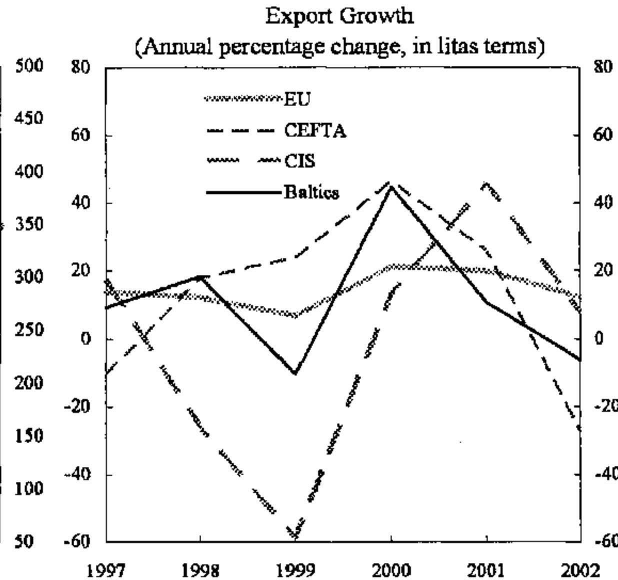
	1999	2000	2001	2002	2003	
					Act. Q1 1/	Proj.
	(Annual percentage change; unless otherwise specified) 2/					
Real GDP	-1.8	4.0	6.5	6.7	9.4	5.8
Average CPI	0.8	1.0	1.3	0.3	-1.7	0.0
Unemployment rate (end-of-period, in percent) 3/	10.0	12.6	12.9	10.9	9.4	...
Average wages (in litas) 4/	6.2	-1.7	0.9	5.0	3.4	...
Real domestic demand	-0.4	2.0	5.7	6.3	6.6	6.7
Consumption	0.1	5.9	3.0	4.8	4.0	6.2
Investment	-2.1	-11.8	17.0	11.6	19.1	8.6
Real exports	-16.8	9.8	21.2	19.5	15.4	14.4
Real imports	-12.4	4.7	17.7	17.4	10.3	15.2
	(In percent of GDP; unless otherwise specified)					
Consumption	87.2	86.3	84.5	83.0	81.4	82.8
Investment	23.1	20.2	21.0	22.6	18.9	23.0
Exports	39.8	45.7	50.9	54.1	58.0	54.9
Imports	50.1	52.2	56.4	59.8	58.3	60.7
Fiscal balance 5/	-8.5	-2.8	-2.0	-1.2	0.8	-1.8
Current account balance	-11.2	-6.0	-4.8	-5.3	-3.7	-5.7
Gross official reserves (in millions of U.S. dollars)	1,244	1,344	1,657	2,400	2,874	2,850
Broad money (year-on-year change, in percent)	7.7	16.5	21.4	16.9	15.6	13.7
Private sector credit (year-on-year change, in percent)	13.8	-1.2	15.4	30.4	30.8	28.0

Sources: Lithuanian authorities; and Fund staff estimates and projections.
1/ The figure for the unemployment rate refers to June 2003.
2/ Growth rates for the first quarter of 2003 are based on a comparison with the first quarter of 2002.
3/ Beginning in January 2003, the estimate of the labor force was revised downward causing a one-time increase in the unemployment rate of 0.8 percentage points.
4/ After 1999, data exclude salaries of owner-operated enterprises.
5/ In percent of annual GDP. The figures for 2003 include the early repurchase of Lithuania's EFF by the BoL in net lending, which reduces the annual deficit by 0.3 percent of GDP.

Figure 3. Indicators of External Competitiveness, 1996-2003



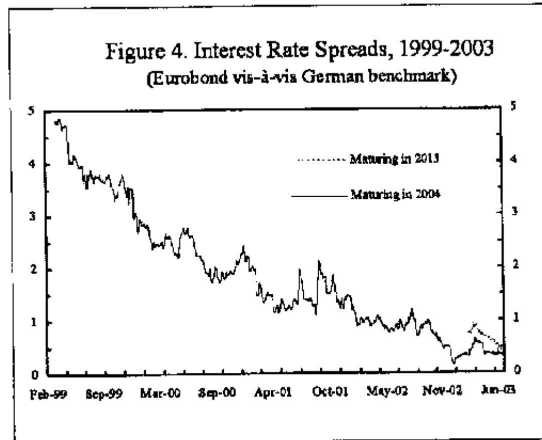




Sources: Lithuanian authorities; and Fund staff estimates.

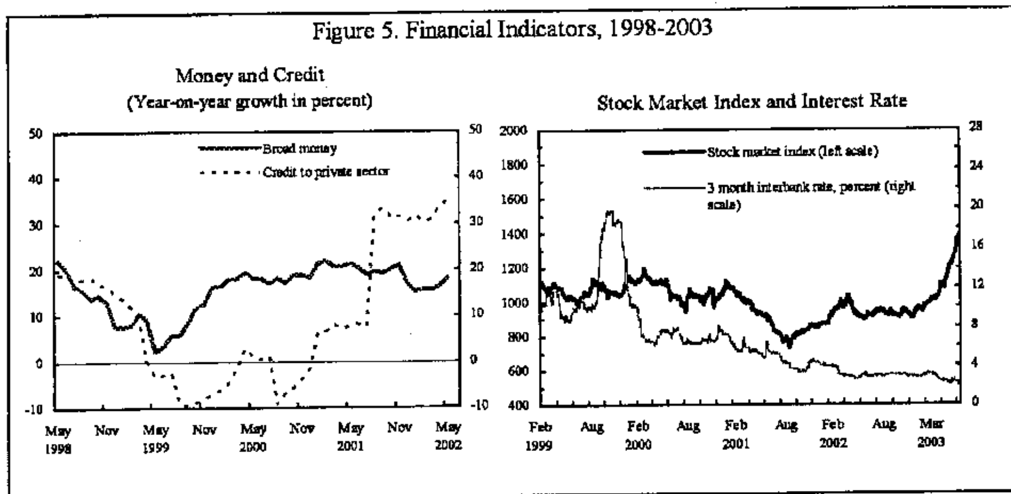
which was trading at a spread of 45 basis points in mid-July (Figure 4).[1] Against this background, gross official reserves reached $2.9 billion at end-March 2003 (covering more than 3 months of imports and just under 100 percent of short-term debt, on an original maturity basis, at end-2002). Preliminary data for the first quarter of 2003 show that the current account deficit narrowed to 3.7 percent of quarterly GDP, reflecting an improvement in the trade balance.

Figure 4. Interest Rate Spreads, 1999-2003
(Eurobond vis-à-vis German benchmark)



4. **Monetary and credit aggregates expanded further in 2002 and the first quarter of 2003.** Broad money has been expanding rapidly since 2000 due to the improved economic environment and greater confidence in the banking sector. Credit to the private sector started expanding in late 2001, reflecting improved business confidence, a decline in interest rates, and greater competition and efficiency of the newly privatized banks. Broad money grew by 18.2 percent year-on-year by end-May 2003, with monetization gradually converging toward the level of other advanced transition countries, reflecting improved economic conditions and enhanced confidence in the banking system (Table 3, Figures 5-6). Cash in circulation grew significantly, partly

Figure 5. Financial Indicators, 1998-2003

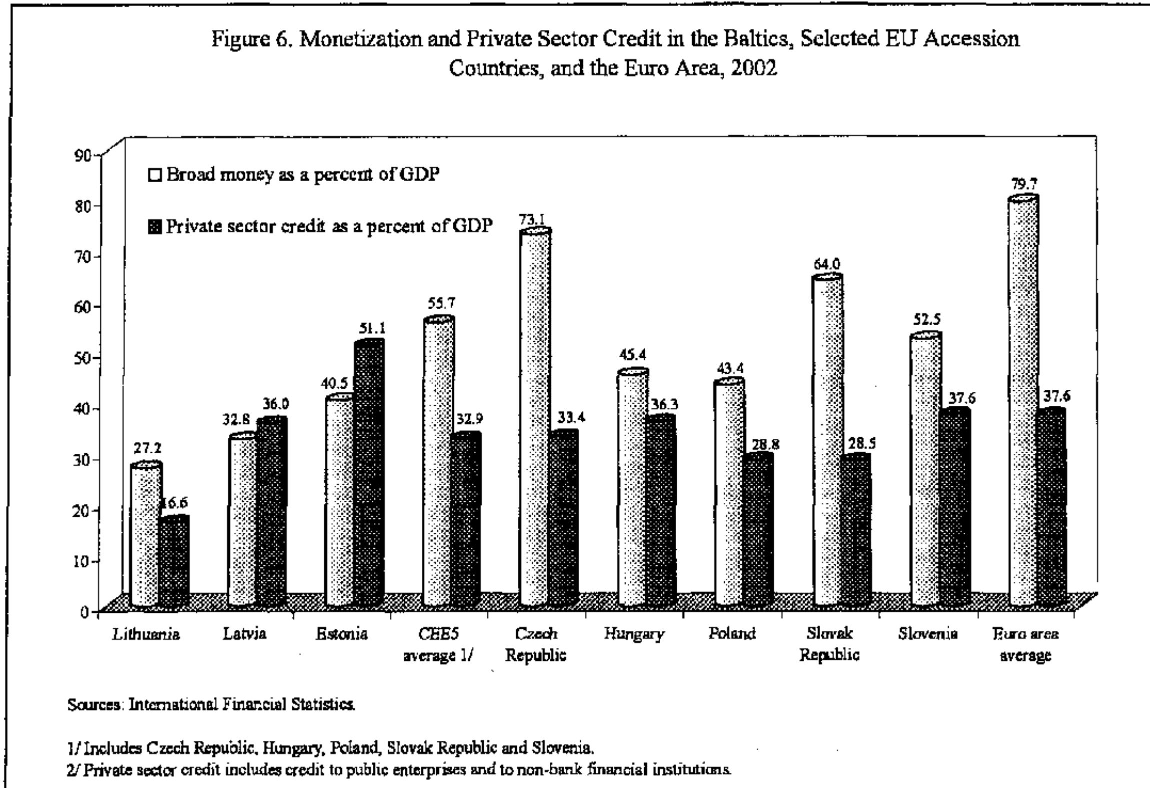


reflecting the conversion of dollars into litai, in response to the dollar depreciation. Credit to the private sector expanded rapidly, by 35 percent, albeit from a low base, in response to low interest rates and increased economic activity. The reserve coverage of the currency board remains high at 155 percent at end-May, and interest rates continue to be low, in line with

[1] Standard & Poor's upgraded its rating on long-term sovereign credit in foreign currency for Lithuania from BBB to BBB+ in February 2003.

EU rates. Significant progress was made in implementing FSAP recommendations (see Supplement 1).

Figure 6. Monetization and Private Sector Credit in the Baltics, Selected EU Accession Countries, and the Euro Area, 2002



Sources: International Financial Statistics.

1/ Includes Czech Republic, Hungary, Poland, Slovak Republic and Slovenia.
2/ Private sector credit includes credit to public enterprises and to non-bank financial institutions.

5. **The strong fiscal consolidation initiated in 2000 continued in 2002 and in the first quarter of 2003**. The general government budget recorded a deficit of 1.2 percent of GDP in 2002 (compared with 2 percent in 2001), and a surplus of 0.8 percent of annual GDP in the first quarter of 2003 (Table 4). In the first quarter of 2003, revenues were broadly in line with the budget, as shortfalls in the corporate income tax (CIT) and other taxes were offset by higher-than-budgeted collection of personal income tax (PIT) and non-tax revenue. Expenditure was lower than budgeted by almost 0.5 percent of GDP, mainly due to savings in interest and low layouts in goods and services.

6. **Structural reforms continued during the past year, although with some disappointments.** Tax reforms brought the tax system basically in line with EU requirements, but revenue failed to stabilize. Cost-cutting measures successfully reduced pharmaceutical expenditures of the Health Insurance Fund (HIF), and measures to improve municipal finances were implemented, but expenditure arrears persisted, and further reform steps envisaged for early 2003 were postponed in the wake of municipal elections. In 2002,

the last state-owned bank was privatized, a 34 percent stake in Lithuanian Gas was sold to a German consortium, and Russia's Yukos took a controlling stake in the Mazeikiu Nafta oil refinery, ensuring long-term supplies. In addition, bankruptcy regulations were strengthened, and a new labor code became effective at the start of 2003. Substantial progress was also made in implementing projects funded by EU pre-accession grants, particularly in agriculture, an area facing large restructuring needs. The privatization process was recently subject to delays, with protracted negotiations for the sale of another 34 percent stake in Lithuania Gas to Russia's Gazprom, and a cancellation of the tender for Lithuanian Airlines.

III. Report on the Discussions

A. Retrospection

7. **The Lithuanian authorities and civil society involved in the discussions assessed very favorably the economic performance under the recent Fund-supported programs.** When Lithuania embarked on the program in March 2000, it was in the midst of both a political crisis and a recession. Three years later, Lithuania had achieved macroeconomic stabilization, high growth, and a significant breakthrough in structural reforms; restored credibility; and is in the first wave of EU accession. This turnaround happened against the background of three successive governments, a steep nominal appreciation of the litas, the lack of a long-term oil supply contract, and rising unemployment.

8. **The general view was that the Fund programs had played a catalytic role in bringing about the turnaround, with financing considerations secondary.**[3] Fund programs helped to create consensus across a fragmented political spectrum on the economic policies needed to achieve the widely shared goals of preserving the CBA and joining the EU. Such consensus allowed strong fiscal adjustment to take place and enabled the passage of needed legislation. The programs also supported the BoL's strategy of a preannounced repegging of the litas from the dollar to the euro at the prevailing exchange rate, emphasizing stability and transparency. This approach worked because wage flexibility and enterprise restructuring helped maintain competitiveness and successfully reorient exports to the EU. In the authorities' view, discussions with the staff and the outreach efforts had contributed to the internal debate, leading to true domestic ownership of the final decisions. This inclusive approach permitted continuity when changes of government took place. The authorities considered that cooperation with the Fund had been very good, with an open constructive dialogue. Looking at what could have been done differently, they believed that the program targets for the general government budget deficit were initially too ambitious, but the programs had been adequately adjusted over time.

9. **The staff believes that the programs were generally successful in delivering macroeconomic stabilization and restoring credibility.** The commitment of the authorities

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[3] The arrangements were treated as precautionary and no purchases were made.

was the crucial factor. Despite political upheavals, a key set of politicians and technocrats believed in the reforms and pushed for their implementation, even when politically difficult. The staff believes that a strong upfront fiscal adjustment was necessary, but some flexibility was shown in revising the program when warranted. Fund and World Bank technical assistance in key areas was used effectively. In the staff's view, the main weaknesses in program implementation occurred in some structural areas, where the consensual approach led to political compromises: the tax reform fell short of expectations; fundamental problems in municipalities and social spending remain; meaningful pension reform was essentially postponed (Box 1); and energy privatization was subject to delays. Fund surveillance was effective in this period: the Article IV discussions identified the key challenges confronting the authorities, who were generally receptive to the recommendations.

B. Discussions with the Authorities

10. **The authorities' main macroeconomic targets are maintaining high and employment-generating growth with low inflation, and safeguarding the external position.** In their view, joining the EU should help achieve these targets. Their strategy aims at keeping the CBA within ERM II until the adoption of the euro, implying that fiscal policy and structural reforms will remain the key policy instruments.

11. **The discussions focused on the following issues relevant to macroeconomic stability:**

- ***The medium-term outlook and external vulnerabilities, and the possible implications of prolonged economic weakness in Europe and an appreciating euro;***
- ***The exchange rate and monetary framework before and after EU accession;***
- ***Preserving the quality of banks' credit portfolios in a period of rapid economic growth and credit expansion;***
- ***The medium-term fiscal stance and the short-term challenges of making room for EU-related costs; and***
- ***Structural reforms and a strengthening of the social safety net, to address high unemployment and regional inequalities.***

Box 1. The Pension System: Long-Term Problems and Solutions

The Lithuanian pension system is administered by the State Social Insurance Fund Board (SoDra) and operates on pay-as-you-go (PAYG) principles. The system is financed by 25 percentage points of the 34 percent social security tax, with special arrangements for farmers and the self-employed. Three types of pensions are provided—old-age, disability, and survivor—at a cost of 6.8 percent of GDP in 2002, with old-age pensions accounting for more than 70 percent of expenditure. In addition to SoDra pensions, a number of pension programs are financed by the state, which cost about 0.6 percent of GDP (see tables).

To be eligible for an old-age pension individuals must reach retirement age and contribute for at least 15 years (30 years to get full benefits). The old-age pension has two components: a flat basic pension, currently about $45 a month (19 percent of the average net wage), and an earnings-related pension of on average about the same magnitude. The basic pension is in principle indexed to inflation and earnings-related pensions to the average wage. However, during the last few years the basic pension has been increased substantially faster than inflation. Given the ceiling on the earnings-related component the system is highly redistributive. Primarily as a result of demographic developments, the PAYG pension system has recently started to generate surpluses, reflecting relatively large cohorts of workers entering the labor force (due to a period of high fertility rates from the 1960s to the mid-1980s) and a relatively small number of new retirees (due to a low birth rate during the 1940s). This favorable situation is set to continue through about 2015 (see figure).

The pension system faces two serious problems. First, only about 60 percent of the working age population is currently making contributions, so many will not qualify for a future pension. This contrasts with the present situation where almost all those of retirement age are covered, reflecting notionally full employment in the Soviet period, and it is especially worrying given the lack of a targeted social safety net. Second, the decline in the fertility rate from above 2 in the 1980s to currently under 1.3 will over the coming decades entail a dramatic rise in the number of retirees per worker. It is projected that the population will fall by about 30 percent by year 2060, with the dependency ratio almost doubling during the 40 years from 2015. Consequently, the surplus of the PAYG pension system, which is projected to reach about 1 percent of GDP in 2015, would turn into a substantial deficit by mid-century.

To address shortcomings, a number of legal changes were instituted in recent years, including a tightening of provisions regarding farmers and the self-employed and a gradual increase in the statutory retirement age to 62.5 years for males and 60 years for females (by 2006). Also, parliament introduced in late 2002 a pension reform law, which on a purely voluntary basis and starting in 2004 will allow people to switch part of their pension contributions into authorized private pension funds, thereby establishing a funded "second pillar" of the pension system. The magnitude of the contribution, and hence the loss of revenue to SoDra, is initially set to 2.5 percentage points rising to 5.5 percent in 2007. The effect of this last reform is still highly uncertain, but it is probably minimal, as only few are expected to opt in.

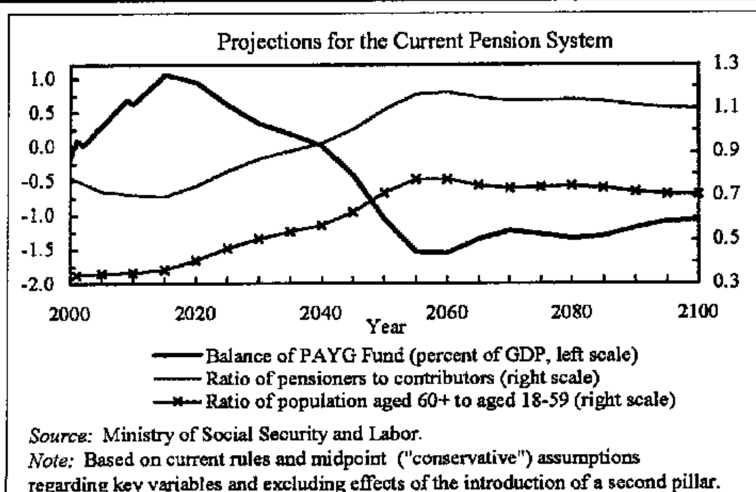
Ensuring the long-term sustainability of the pension system will require additional measures. In this regard, the PAYG scheme would benefit from: (i) further increasing the retirement age to reflect greater longevity; (ii) changing eligibility requirements for old-age pensions to reward service longer than 30 years; (iii) strengthening collection of contributions to increase revenues and coverage; (iv) eliminating the ceiling on the earnings-related pension or cap contributions to reduce the level of redistribution and improve incentives; and (v) tightening eligibility requirements for disability pensions, where the number of recipients has been growing rapidly. Also, to secure participation in the second pillar and encourage the development of private pension funds it would be advisable to: (i) make participation in the second pillar mandatory for younger cohorts, as originally proposed; and (ii) strengthen the regulation of pension funds to increase transparency and install confidence in the market. Finally, it would be desirable to reduce the number of pension schemes, possibly by replacing social assistance pensions, state pensions, and the basic pension with a single scheme.

Pensions and Pensioners, 1995-2001							
	1995	1996	1997	1998	1999	2000	2001
Pensioners (thousands, end-of-year)	906	914	920	931	941	955	948
Of which: Old-age pensioners	657	655	651	648	645	645	637
Disability pensioners	139	147	152	159	166	174	181
Average old-age pension (in LTL)	151	192	243	288	310	313	318
Average disability pension (in LTL)	139	177	222	261	279	280	278
Total pension expenditure							
in LTL million	1,569	2,197	2,691	3,255	3,566	3,591	3,558
in percent of GDP	6.3	7.0	7.0	7.5	8.4	8.0	7.5

Source: Department of Statistics

Cross-Country Indicators, 2000				
	Statuatory Retirement Age (male/female) 1/	Dependency Ratio (%) 2/	Public Pension Expenditure (% of GDP)	Total Fertility Rate
Lithuania	62.5/58.5	36.0	8.0	1.27
Estonia	63/58.5	39.4	7.6	1.39
EU	...	39.2	10.4	1.53
Austria	65/60	35.9	14.5	1.32
Denmark	65	34.8	10.5	1.76
Finland	65	35.8	11.3	1.73
France	60	38.3	12.1	1.89
Germany	65	41.3	11.8	1.34
Greece	65	42.0	12.6	1.30
Italy	57	42.5	13.8	1.25
Portugal	65	38.8	9.8	1.54
Spain	65	38.1	9.4	1.22
Sweden	65	41.3	9.0	1.54
U.K.	65/60	37.6	5.5	1.64

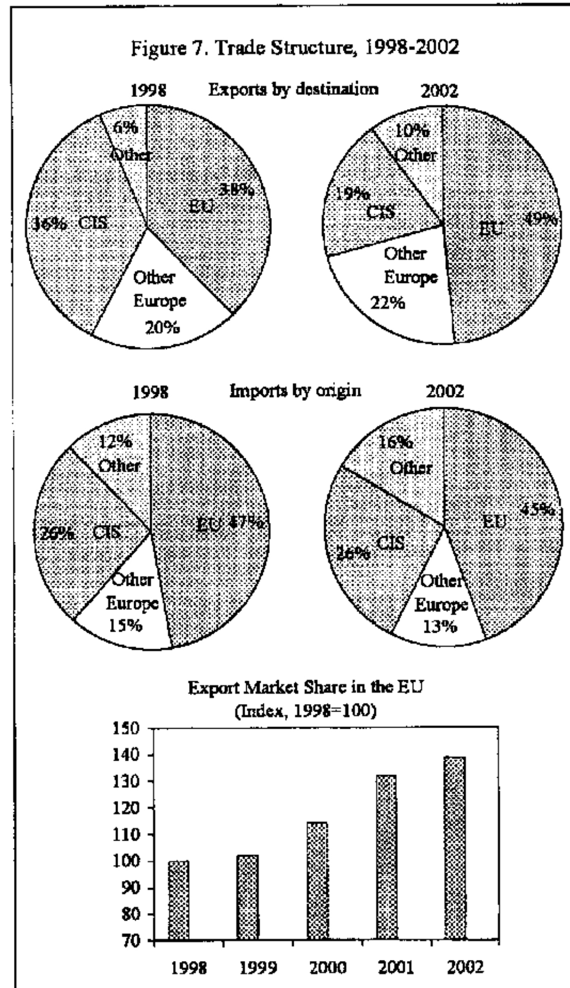
1/ Main public old-age pension in 2002/03.
2/ Ratio of population aged 60 and over to aged 20-59.
Sources: SSA, Eurostat, European Policy Committee, and national statistics.



Source: Ministry of Social Security and Labor.
Note: Based on current rules and midpoint ("conservative") assumptions regarding key variables and excluding effects of the introduction of a second pillar.

C. The Economic Strategy for the Medium Term

12. **The potential for sustained economic growth is in place, but continued sound policies are needed.** The stable macroeconomic environment and the restructuring undergone in the past three years have enabled businesses to achieve strong sales and profit growth (Figure 7). Investors are optimistic and are starting to look beyond export industries, which, nonetheless, would continue to be the main engine of growth. Provided prudent macroeconomic policies and structural reforms to improve the business environment are in place, the economy could continue to grow rapidly, with further advances in productivity, modest inflation, and gradually declining unemployment (Annex I). EU accession will provide additional stimulus due to the inflow of grants and opportunities created by further integration of trade and finance. In 2003, real GDP growth would decelerate to about 5.8 percent, due to the impact of slow growth in partner countries. Growth would then pick-up somewhat, to 6.2 percent in 2004-05, reflecting a projected economic recovery in the EU and increased investment associated with the availability of EU structural funds (Table 7).



13. **Over the medium term, Lithuania's current account deficit as a share of GDP and the external debt ratio are expected to decline** (Tables 2a and 2b). Notwithstanding robust export growth, the current account deficit would temporarily widen during 2003-04, reflecting the import content of investment and the boost to private consumption and infrastructure investment provided by EU transfers.[4] The larger deficit mirrors the fiscal expansion projected for this period. After 2005, the current account deficit as a share of GDP would gradually start narrowing, mainly reflecting increasing public saving as fiscal consolidation resumes, and is projected to decline to under 5 percent of GDP by 2008. The

[4] The authorities classify EU structural funds as (non-debt-creating) capital rather than current transfers.

baseline scenario makes a conservative assumption on FDI flows, to reflect the declining privatization potential over time—should FDI flows prove to be higher, the economy could sustain a somewhat wider current account deficit over the medium term. The external debt ratio is projected to decline steadily, from 45 percent in 2002 to 35 percent in 2008.

14. **The authorities agreed that Lithuania's external position remains vulnerable to a number of potential shocks**, due to large gross financing needs in the medium-term. Prolonged economic weakness in Europe or a further appreciation of the euro might affect competitiveness and export growth. Higher international interest rates, and/or a decline in capital inflows to emerging markets could also adversely affect Lithuania's external position (Annex II).

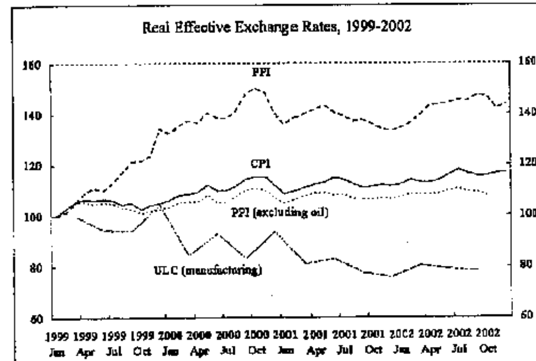
D. The CBA and Monetary and Financial Policies

15. **The authorities reiterated their intention of maintaining the CBA until an early adoption of the euro.** Their proposed strategy is to join the ERM II very soon after accession, maintaining the current parity and an unilateral commitment to the CBA, and adopt the euro after two years of successful membership of ERM II and continued compliance with the Maastricht criteria, subject to agreement with the relevant EU authorities. The staff recognized the benefits in terms of stability of the authorities' strategy. A double regime shift within a short period of time could increase uncertainty and could prove very costly. In addition, an early adoption of the euro would not entail a loss in policy flexibility compared with the current monetary framework, while further bolstering confidence, reducing interest spreads, and lowering transaction costs. The staff also pointed out the risks. For this approach to succeed, domestic policies—in particular fiscal policy—must continue to be supportive and competitiveness remain appropriate (Box 2). While there is no indication of exchange rate misalignment at present, a joint assessment of competitiveness will have to be made by the authorities and the EU when entering ERM II. Moreover, with income convergence or large capital inflows the Maastricht inflation criterion might be exceeded.

16. **Rigorous banking supervision is needed to protect financial sector stability at a time of rapid growth of money and credit.** In 2003, broad money is projected to grow by 13.7 percent, reflecting further financial deepening and technological improvements in the banking sector (Table 3). Credit to the private sector would continue to expand by 28 percent, boosted by favorable economic conditions and low interest rates. The staff and the authorities shared the view that this credit expansion does not pose an immediate risk and remains manageable in view of the results of the FSAP follow-up, the low credit base, and the current favorable macroeconomic conditions. However, this situation will require continued close monitoring and a sound credit risk management system in order to safeguard

Box 2. Competitiveness in Lithuania: Waiting for Balassa-Samuelson

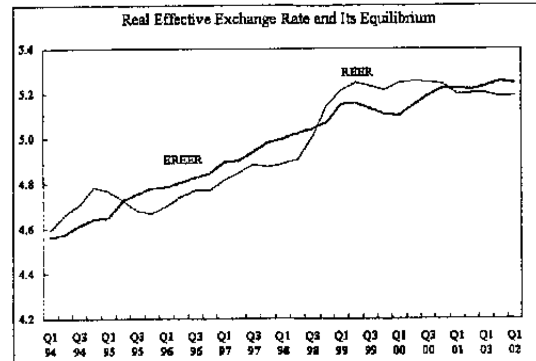
As Lithuania approaches participation in ERM II, which requires the choice of a central parity vis-à-vis the euro, evaluating the country's competitiveness is key to assessing the sustainability of Lithuania's exchange rate regime. Based on the results of the background paper on competitiveness in the Baltics (SM/03/118) for the period 1994-2002, Lithuania appears to have maintained its competitiveness, as suggested by a range of indicators:



Real effective exchange rate (REER) indicators (figure). REERs strongly appreciated in the mid- and late- 1990s. Since early 1999, the appreciation of the dollar against the euro and later the appreciation of the euro against the dollar—following the litas repegging—led to an appreciation of Lithuania's effective exchange rate of 16 percent in 1999-2002. This appreciation was partially offset by low inflation rates than those in the trading partners, as shown by the CPI-based REER. Since 1999, the producer price-based REER (excluding oil) appreciated by under 10 percent, less than the appreciation in the CPI-based measure. The unit labor cost (ULC)-based REER was about 20 percent lower in mid-2002 than in early 1999, due to very low wage increases and exceptionally high increases in productivity in the context of the strong recovery following the 1999 recession.

Export performance. Despite the EU slowdown, Lithuania has expanded the share of its exports in the EU market by a remarkable 50 percent since 1999. Lithuania's export base is quite diversified, with oil, textile, machinery and equipment, all contributing significantly to export growth.

Productivity growth. Although the gap between income and productivity levels in Lithuania and in the euro area remains very large, convergence is taking place. GDP per capita and per worker growth rates averaged 6.3 percent and 6.8 percent a year, respectively, for the period 1994-2002, almost double the EU average. Estimates of total factor productivity (TFP) suggest that the rapid growth in output in Lithuania over 1995-2001 primarily reflect TFP growth, which is estimated to have contributed about 3 percentage points to annual GDP growth.



Equilibrium REER (EREER). Based on an estimation of the EREER in a theoretical framework that incorporates the Balassa-Samuelson hypothesis and the balance of payments approach, there is evidence that the EREER has appreciated significantly since 1994, although the rate of appreciation has slowed down since the beginning of 1999 (figure). At the beginning of 2002, the REER appears to be lower than the EREER, by anywhere from 2½ percent to 8¼ percent. Alternative methods that identify underlying trend movements produce similar results. The strength of the euro in the last year, however, may have removed some of this difference.

Balassa-Samuelson. Based on this evidence, the authorities' monetary strategy would be viable provided cautious policies are maintained. One concern is that, with a fixed exchange rate, the ability to meet the Maastricht inflation criterion will depend on the scale of the Balassa-Samuelson effect. But high productivity growth has not affected prices in Lithuania so far. The lack of evidence for the Balassa-Samuelson effect is possibly explained by the fact that productivity in non-tradables sector has also grown very fast, as large technical advances have taken place in the non-tradables sector for services such as electricity distribution, finance services, and telecommunications, thanks to restructuring and privatization. Productivity growth in the retail sector has also been very large. This development would be consistent with the findings of Harberger ("Economic Growth and the Real Exchange Rate: Revisiting the Balassa-Samuelson Effect", paper for a conference organized by the Higher School of Economics, Moscow, 2003) for numerous high-growth countries.

the quality of the banks' credit portfolio and the country's external position.[5] In this context, the staff endorsed the BoL's intention of lowering very gradually, in three to four steps, the required reserve ratio from its current level of 6 percent toward the required ECB level of 2 percent by 2007 but recommended caution. While overheating remains unlikely in the near term, credit expansion or large capital inflows could give rise to inflationary pressures in the future and the pace of the reduction would have to be reconsidered.

17. **Since the November 2001 FSAP, financial markets in Lithuania have developed while remaining stable.**[6] The foreign exchange market has grown considerably and is the most developed. With bank privatizations finalized, the banking system has exhibited steady strengthening and increased soundness of prudential indicators. Measures recommended by the FSAP report in the Basel Core Principles for Effective Banking Supervision have been largely implemented in the new draft Law on Banks. The draft also enhances the BoL's ability to detect and prevent money laundering. Most issues regarding insurance supervision have been addressed by a new draft Law on Insurance; however, limits on the financial independence of the insurance supervisory agency raise concerns given its new responsibility for pension fund supervision.[7] Regarding debt management, the government's savings securities program, originally intended to attract the nonbank public to capital markets, introduced distortions instead, proving costly to the budget and posing a risk in case of a sudden encashment of the outstanding stock. Following the staff's advice, the government suspended the issuance of new savings securities in June.

E. Fiscal Policy and Fiscal Structural Reforms

18. **Looking ahead at EU membership and the obligations of the Treaty, the authorities reiterated their commitment to keeping low fiscal deficits in the short run and reaching a structurally balanced budget in the medium term**. Moving towards a structurally balanced budget, a requirement under the Stability and Growth Pact, would bolster the credibility of the CBA, help maintain low interest spreads, limit the public sector's call on national savings, and safeguard the external position. This strategy would also provide some room for maneuver if countercyclical policies were needed and would prevent an upward drift in public debt. The staff endorsed the authorities' strategy, underscoring the challenges that they will face in the short run. In particular, prioritization of

[5] Credit to the private sector was 16.6 percent of GDP in 2002, compared to 36 percent in Latvia and 51.1 percent in Estonia (Figure 6). It is projected to increase to 20.6 percent in 2003.

[6] See Supplement 1 for details on the FSAP follow-up and SM/03/122.

[7] The agency's salary structure and employment of staff will remain determined by the Law on Civil Servants. As a result, salaries might not be sufficient to retain the necessary highly specialized staff, such as actuaries (see Supplement 1).

expenditure remains key to foster productive investment and promote efficient social spending. Equally important is the need to increase revenue by improving tax administration, eliminating preferential treatments, and promoting good governance and transparency.

19. **The authorities explained that, in 2003-04, the budget deficit is expected to increase to accommodate upfront expenditures related to EU membership, leading to a deviation from the medium-term path** (Text Table 2). Given the current strong economic position, the good track record of prudent policies, and the authorities' commitment to medium-term balance, the staff took the view that this widening of the deficit would not jeopardize macroeconomic stability, provided it remains limited and temporary, as envisaged by the authorities.

Text Table 2. Fiscal Impact of EU Accession, 2003-06 1/

	2003	2004	2005	2006
	(In millions of litai)			
Net cash flow	613	863	1,300	1,318
Grants	613	1,381	2,028	2,065
Pre-accession instruments	605	470	394	252
Post-accession instruments	...	778	1,229	1,349
Refunds for agriculture	...	...	382	440
Budget support	8	133	24	24
Payments to the EU	...	-518	-728	-747
EU-related expenditure	1,393	3,049	3,555	3,405
Spending of grants	605	1,248	1,622	1,601
Co-financing	212	467	438	421
National investments	109	124	105	5
Administrative capacity building	467	310	222	142
Agriculture	...	382	440	489
Payments to the EU	...	518	728	747
	(In percent of GDP)			
General government revenue and grants	30.3	31.2	31.6	31.5
Of which: grants	1.1	2.3	3.2	3.0
General government expenditure	32.1	33.8	33.6	33.0
EU-related expenditure	2.6	5.2	5.6	4.9
Of which: payments to the EU	0.0	0.9	1.1	1.1
Other	29.5	28.6	28.1	28.1
Of which: discretionary spending 2/	17.5	17.0	16.7	17.0
Fiscal balance 3/ 4/	-1.8	-2.6	-2.1	-1.5

Sources: Lithuanian authorities; and Fund staff estimates and projections.
1/ Assumes full absorption of available post-accession grants and topping up of direct payments to farmers up to 40 percent of EU level.
2/ Defined as total expenditure less EU-related expenditure, benefits paid by SoDra, defense spending, and interest.
3/ 2003 discrepancy between above and below the line (-0.5 percent of GDP) assigned to expenditure.
4/ Figures for 2004-06 are staff projections.

20. **The staff underscored the importance of holding the general government fiscal deficit for 2003 at the budgeted 2.1 percent of GDP** (Table 4) (1.8 percent adjusted for an EFF early repurchase).[8] The authorities stated that they would cut discretionary expenditure to meet the fiscal target should revenue shortfalls materialize. A supplementary budget, approved by Seimas in July, entailed some expenditure reallocation but left the authorities' fiscal deficit target for the year unchanged. The staff indicated, however, that the reallocations in favor of agriculture (almost 0.2 percent of GDP) set a bad precedent, and stressed the importance of resisting political pressures for additional spending or preferential treatment to some sectors of the economy. The financing of the general government deficit remains as originally budgeted.

21. **The authorities noted that expenditure pressures are expected to intensify in 2004, but they would aim at keeping the budget deficit below 3 percent of GDP.** The tax revenue-to-GDP ratio will decline further, reflecting the impact of the tax reforms and further changes to the tax system likely to be required by the EU (Text Table 3). EU-related expenditure will increase by 2.6 percent of GDP.[9] In addition, spending pressures may mount in the run-up to parliamentary elections. Careful expenditure prioritization is therefore needed to preserve essential services and social expenditure.[10] The staff emphasized that there is no room for topping up EU-related payments to farmers from national funds[11] or scope for accelerating the saving and land restitution

Text Table 3. Estimated Losses in 2004 Associated with Tax Concessions
(In millions of litai)

VAT	
Introduction of reduced 5 percent on meat 1/	40
Introduction of reduced 5 percent rate on hotels 1/	23
PIT	
New deductions (pension contributions, study, and life indurance)	86
Excises taxes	
Elimination of tax on diesel for agricultural use	65
Total	214

Sources: Country authorites and Fund staff estimates.
1/ Change imposed by Seimas to the original tax reform proposal presented by the government. This concession became effective in 2003.

[8] The non-budgeted repurchase to the Fund of SDR 39 million was made in January 2003.

[9] Part of these EU-related expenditures (about 0.9 percent of GDP) would overlap with expenditures that would have taken place in any case.

[10] Initiatives to mandate expenditure in certain sectors could impede prioritization. In this regard, in December 2002, Seimas approved an amendment to the Health Insurance Law effective on January 1, 2004, establishing the minimum amount of annual transfer from the State Budget to the HIF. The authorities are trying to postpone the implementation date of the amendment, which would imply an additional outlay of 0.5 percent of GDP in 2004.

[11] Direct payments to farmers at 40 percent of the current EU level will be compensated by EU funds in 2005. If Lithuania were to pay farmers 55 percent (the upper limit allowed by the EU), the additional 15 percent (0.3 percent of GDP) would have to be financed from national resources.

plans.[12] The authorities are in the process of preparing the 2004 fiscal deficit and they indicated that they intend to keep it somewhat below 3 percent of GDP. The staff noted that, at this stage in the economic cycle, there is the need to leave some room for counter-cyclical fiscal policies in the event of a slowdown or adverse external shocks and still remain in compliance with Maastricht criteria. The staff argued that a fiscal deficit of about 2.6 percent of GDP would provide such room, accommodate EU-related expenditure, and allow non-EU related expenditure to grow in real terms, although at a slower pace than GDP (Text Table 4).[13] The authorities considered the staff's proposal useful and they will take it into account for the preparation of their budget.

Text Table 4. Fiscal Balance of the General Government, 1999-2004

	1999	2000	2001	2002	2003	2004
	(In percent of GDP)					
Revenue and grants	32.1	30.7	30.1	30.5	30.3	31.2
of which: revenue	32.1	30.7	30.1	29.8	29.2	28.8
Expenditure and lending	40.3	33.6	31.7	31.4	32.6	33.8
of which: expenditure	37.9	32.9	31.6	31.6	32.7	33.7
Discrepancy	0.4	-0.1	0.3	0.3	-0.5	0.0
Fiscal deficit 1/	-8.5	-2.8	-2.0	-1.2	-1.8	-2.6

Sources: Country authorities, and Fund staff estimates.
1/ Staff proposal for 2004.

[12] Total outstanding claims under the land and saving restitution programs amounted to about LTL 3.5 billion (6.5 percent of GDP) in June 2003.

[13] The following assumptions underlie the staff's 2004 fiscal deficit projection. On the revenue side, an overall revenue loss of 0.4 percent of GDP would be offset by the introduction of a tax on transportation and higher excises on gas and fuel (about 0.2 percent of GDP), and by the budget support funds from the EU (0.2 percent of GDP). On the expenditure side, some EU-related expenditure could be accommodated within existing budget allocations (0.9 percent of GDP). Other additional EU-related expenditure –support to farmers (almost 0.7 percent of GDP), EU-membership fee (0.9 percent of GDP) and part of post-accession programs (almost 0.2 percent of GDP)– could be virtually accommodated by savings in interest (0.1 percent of GDP) and by reducing spending in wages and salaries (by 0.2 percent of GDP), non EU-related expenditure in good and services (by 0.5 percent of GDP), and SoDra outlays (by 0.2 percent of GDP).

22. **The decline in the tax revenue-to-GDP ratio raises major concerns.** The tax reform failed to stabilize revenue in GDP terms, mainly owing to concessions awarded by Seimas on VAT, PIT, and excise tax, estimated at almost 0.4 percent of GDP in 2004 (Text Table 5). Further revenue losses are likely to materialize in 2004 if the elimination of the turnover tax and the excise tax on sugar are required by the EU (0.9 percent of GDP in subsequent years). The authorities and the staff shared the view that alternative sources of revenue to offset these losses are needed. These could include a tax on transportation (estimated revenue of LTL 65 million for the first year and LTL 100 million thereafter), and higher duties and excises on oil products and gas. The staff also encouraged the authorities to persevere in their efforts to improve tax administration and fight tax evasion.

Text Table 5. Impact of Approved Legislative Changes Effective in 2004
(In millions of litai)

Tax	Impact
Value added tax	152
CIT	125
PIT	-118
Higher taxes	35
Elimination of tax on sugar 1/	-58
Elimination of turnover tax 1/	-212
Overall impact	-76

Sources: Country authorities and Fund staff estimates.
1/ Not yet approved by Seimas, but likely to be requested by the EU.

23. **The staff welcomed the marked improvement in the HIF's financial prospects, but emphasized that further efforts are needed to enhance the efficiency of the health sector**. The measures implemented in 2001-02 to limit HIF's pharmaceutical expenditures (see EBS/03/14) have started to bear fruit—the HIF's budget was in balance at the end of 2002 and in line with the budget in early 2003, though some arrears persist. The authorities agreed that improving further the administration of the HIF and developing a long-term plan for rationalization of expenditure and infrastructure are needed to create an efficient and financially viable health care system. A first step was made in March 2003 with the publication of the criteria for restructuring hospitals.

24. **The authorities noted the improvement in the overall financial situation of municipalities in 2002, but acknowledged that the underlying problems have not been resolved**. Municipalities reduced substantially their arrears by end-2002 (by LTL 48 million relative to end-2001), mainly because of the favorable economic environment, but accumulated new arrears (LTL 26 million) in the first quarter of 2003. The staff recommended further expenditure rationalization, enforcing borrowing limits, and improving budgeting and planning procedures. Technical assistance in this area has been requested from FAD. In addition, the staff pointed to the need to provide municipalities with control over their tax base and expressed disappointment that the introduction of the real estate tax before the 2004 elections was unlikely.

25. **The amount of EU grants will increase sharply upon accession, when Lithuania will become fully responsible for the approval and oversight of all EU-financed projects.** Two departments were created at the Ministry of Finance to coordinate and monitor EU-related financial issues. Further efforts are being made to enhance administration

capacity and put in place efficient control mechanisms, to ensure that grants are properly used and to prevent financial mismanagement and corruption.

F. Other Structural Reforms

26. **Deeper structural reforms are needed to underpin growth and employment creation.** EU funds will provide resources to help restructure an inefficient agricultural sector, which accounts for 16 percent of employment—well above the EU average (Text Table 6)—but only 8 percent of GDP.[14] The legal framework should be streamlined, to increase transparency and improve the business environment (Box 3). Privatization appears to be picking up speed with a number of large sales expected in 2003, including two electricity distribution companies and four alcohol producers. The fate of the sale of a stake in Lithuania Gas remains uncertain, however. Finally, pension reform would stimulate private savings and financial market development.

Text Table 6. Lithuania and the EU: Employment by Sector, 1990-2001
(In percent of total)

	1990	1995	1999	2001	EU average 2001
Agriculture, forestry and fishing	21	24	20	16	4
Industry and construction	41	28	27	28	29
Services	38	48	53	56	67
Commerce, hotels and restaurants	9	14	16	17	19
Public administration, education, health, social care	14	19	23	25	24
Transport, financial services, real estate, other	16	15	14	14	24
Total	100	100	100	100	100

Sources: Lithuania Statistics Department and OECD.

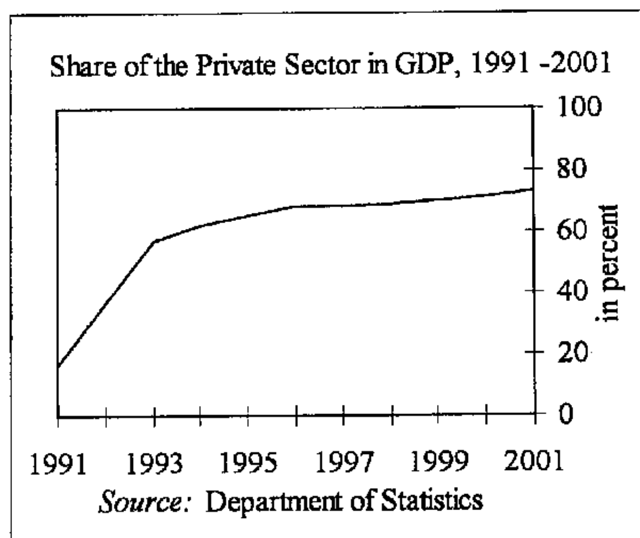
27. **Strengthening the social safety net is crucial.** While unemployment has been declining, regional disparities remain high and rural poverty is widespread, with subsistence farming representing a form of hidden unemployment. The system of social assistance needs to be overhauled and its targeting improved (Box 4). Despite increasing expenditure, the quality of services provided remains substandard in a number of areas, particularly health.

28. **Lithuania maintains an open trading system** with a three-tier tariff structure, with different tariffs applying to imports from countries with MFN status, to those from countries with free trade arrangements, and to those from all other countries. Tariff rates vary widely for different product groups. No changes to the trading system have been introduced since the last Article IV consultation. Looking ahead, however, Lithuania will need to harmonize its tariff system with the EU single tariff system. It is estimated that this will result in a somewhat more restrictive system, as tariffs on imports from some important non-EU trading partners will have to be raised.

[14] Lithuania faces a challenge similar to that of Spain when it joined the EU in 1986: 16 percent of Spanish employment was in agriculture, which accounted for only 5 percent of GDP. By 2001, the contribution of agriculture to GDP was unchanged, but its share in employment had dropped to less than 7 percent.

Box 3. Creating a Favorable Business Environment

From 1991 to 2001, the share of the private sector in GDP increased rapidly from less than 20 to more than 70 percent (Figure), but the private sector was unable to absorb all the labor shedded by the restructuring of the public sector, giving rise to high and persistent unemployment. Improving the business environment, especially for small and medium-sized enterprises (SMEs), therefore constitutes a priority for job creation.



Source: Department of Statistics

Factors that create favorable business conditions include a stable and enabling environment (political and macroeconomic stability, an open trade and investment regime, a sound banking system, flexible labor markets and good infrastructure) and a simple, transparent and enforced legal framework promoting competition. Lithuania has made significant progress in all those areas, but further efforts are needed. According to various surveys (by Lithuanian institutions, the World Bank, and the EBRD), businesses viewed as the main obstacles: complex and changing tax requirements, an unstable and cumbersome legal framework, low-level corruption, lack of financing, and the shortage of skilled workers. Efforts should focus on:

- Improving tax administration, simplifying the system, eliminating exemptions and preferential treatments, and bringing out businesses from the shadow economy.
- Simplifying administration procedures and licensing requirements. Excessive state involvement in the operations of private businesses creates opportunities for corruption.
- Mitigating skill shortages and mismatches between the unemployed and vacancies through a well-targeted education and training system for low-skilled workers and promoting labor mobility.
- Reducing the shortage of financial intermediaries for SMEs by promoting microfinance, especially in rural areas. These institutions would help address the issues of high collateral requirements and short repayment periods encountered by SMEs.
- Completing the privatization of transport and utilities to improve infrastructure.

Box 4. The Social Protection System: A Reform in Waiting

Lithuania's complex social protection system established at independence consists of a state social insurance program (SSIP) and a social assistance program (SAP).

- The SSIP, which includes pensions, unemployment benefits, and health insurance, has its own budget, administered centrally by the State Social Security Fund and the HIF. It is financed through mandatory contributions and from state and local government budgets.

- The SAP includes a cash-transfer program and social services (long-term social care and day care). The cash transfer program provides benefits for selected groups regardless of income (family benefits and social pensions) and income-tested benefits for low-income families (social benefits and utilities compensation). The financing and administration of most cash transfers were decentralized to local governments during the 1990s, but transferred back to the central government from 2002, given poor administrative capacity at the local level.

Several issues must be addressed:

- Total ***social insurance expenditure*** has grown rapidly in real terms and in percent of GDP (from 8 percent in 1996 to 16.7 in 2000), and now accounts for almost half of public expenditure. High payroll taxes established to finance this expenditure hamper job creation and contribute to high and persistent unemployment.
- ***Pensions*** account for the largest share of the SSIP, although the average pension is low.
- Although unemployment is high, and of long duration, ***expenditure on unemployment benefits*** is low, 0.4 percent of GDP (the replacement rate and duration of benefits are low relative to other EU accession countries).
- ***Social assistance programs*** are not well targeted and do not protect the most vulnerable groups from poverty, while creating work disincentives for others. Given the multitude of programs, resources are spread without visible results.
- Large ***territorial differences in the provision of social protection exist***, reflecting regional disparities in economic development, wages and unemployment. The inadequate social insurance for the rural population is particularly worrisome, as many farmers are self-employed and lack insurance for old age and other critical situations.

Better targeting is needed, to create an adequate social safety net for the poorest segments of the population and the unemployed, as unemployment is likely to remain high in the near future, especially in light of forthcoming structural changes in agriculture. In addition, the problem of poor pensioners should be addressed through well-targeted social payments.

IV. Staff Appraisal

29. **The Lithuanian economy continues to perform beyond expectations, and is well positioned to take on the challenges of EU accession.** The authorities are to be commended for their firm implementation of sound economic policies that have led to these favorable results. These achievements should not lead, however, to complacency. Hard-won credibility would be quickly dissipated if the authorities' commitment were to waver. Policies to maintain macroeconomic stability and ongoing structural reforms will be necessary to

ensure improved competitiveness, sustained growth and further reductions in unemployment in the coming years.

30. **The CBA, which has anchored macroeconomic stability, continues to serve Lithuania well.** The authorities' proposed exit strategy is appropriate, provided supportive policies are conducted and competitiveness remains adequate. The staff underscores, however, that the success of this strategy hinges on the ability of the authorities to maintain rigorous fiscal discipline.

31. **In this context, the staff wishes to underscore the importance of meeting the deficit target for 2003 and limiting the 2004 deficit to about 2.6 percent of GDP.** This target is ambitious but feasible, and would leave adequate room for countercyclical policies in the event of a slowdown or adverse external shocks. Careful prioritization is required to accommodate EU commitments, and the staff urges the authorities to resist spending pressures in the run-up to elections since any concessions could jeopardize the fiscal target. With declining revenue, there is no scope for payments to farmers from national funds or for accelerating the saving and land restitution plans. Any slippages that would threaten compliance with the Maastricht criteria and the commitments under the SGP would damage confidence, undermining the CBA, macroeconomic stability and the strategy for an early adoption of the euro.

32. **The staff is very concerned about the decline in tax revenue-to-GDP ratio.** Efforts should focus on eliminating exemptions and loopholes, promoting fairness and transparency, and improving tax administration. In the event the elimination of some taxes is deemed necessary by the EU, the authorities would have to find alternative sources of revenue to offset these losses. Raising sufficient revenue is the precondition for carrying out needed reforms. The staff thus urges the authorities to resist pressures for tax reductions or awarding preferential treatments to particular groups or sectors.

33. **The staff welcomes the authorities' efforts to strengthen administrative capacity, financial controls, and audit capabilities for the utilization of EU funds.** It is essential that these transfers be used effectively and transparently, given the scope for potential mismanagement and even corruption.

34. **Efforts should be made to complete the reforms of municipalities and the HIF, setting their finances on a sound footing.** Further steps should include expenditure rationalization, better budgeting and planning procedures, strict borrowing limits, and concrete measures for arrears reduction. A real estate tax would help provide a stable source of own revenue, and it is regrettable that its introduction has been postponed.

35. **The staff welcomes the efforts by the BoL to implement FSAP recommendations and thereby establish high-quality supervision and reinforce the stability of the banking system.** The system was assessed as sound and resilient to foreseeable shocks. However, in the midst of widespread optimism, with rapid money and credit expansion, strict banking and insurance supervision and high standards in bank credit risk management are required to safeguard the soundness of the financial system. Overheating is unlikely in the near term, but inflationary pressures could emerge in the future and could be exacerbated by credit expansion or large capital inflows. In this regard, the timing of the planned reductions in the required reserve ratio would need to take into account liquidity and inflationary conditions as well as Lithuania's external position. If developments were unfavorable, the authorities should be ready to postpone the reduction of the reserve requirement ratio or tighten the fiscal stance further.

36. **There is a need to accelerate and deepen the structural reform process in order to sustain employment creation and rapid economic growth.** The privatization of the energy and the transport sectors would encourage modernization in these areas. The large but relative unproductive agricultural sector also needs restructuring. In this regard, available EU funds should be used to improve the income-generating capacity of rural areas and not just for direct income support. Further removing red tape and other regulatory obstacles to private sector activity would encourage the development of small and medium-sized companies and hence job creation.

37. **Measures to increase labor market flexibility and mobility would help generate jobs and even out high and increasing regional differences.** The large structural component of unemployment and growing income disparities call for a reform of the social safety net, to improve efficiency and targeting towards the poorest segments of the population.

38. **There is a need to adopt measures that would ensure the long-term viability of the pension system.** The rapidly ageing population will entail substantial increases in public expenditures on pensions for which it is important to prepare. The authorities should expand gradually the scope of the reform by raising contribution rates and making participation mandatory for younger cohorts, fostering the development of private pension funds. Also, it is critical that the surplus projected for SoDra over the coming decade be saved for the future rather than spent on increasing benefits. Any increase in benefits should be financed through new measures, such as increasing the retirement age. Moreover, steps are needed to establish appropriate supervision for the pension funds.

39. **Lithuania continues to improve its statistical base.** A number of measures suggested by data ROSCs have been implemented. In the fiscal area, however, the maintenance of different budget concepts is still a problem, adversely affecting transparency. In this connection, the staff encourages the authorities to implement the fiscal ROSC recommendations.

40. **There are additional risks associated to the authorities' macroeconomic strategy.** Lithuania remains vulnerable to external shocks due to large gross financing needs in the medium term. Prolonged economic weakness in Europe or further euro appreciation might affect competitiveness and export growth. Higher international interest rates, and/or a decline in capital inflows to emerging markets could also have adverse effects on Lithuania's external position. While Lithuania has now access to international financial markets on very good terms, net external debt should be kept low, so as to guard against possible unfavorable external developments.

41. **Despite these concerns, the staff considers that Lithuania's economy is well placed to reap the benefits of EU membership.** Cooperation between the authorities and the Fund is expected to continue to be close in the context of surveillance.

42. Lithuania is expected to remain on the standard 12-month consultation cycle.

Table 1. Lithuania: Selected Macroeconomic Indicators, 1999-2004

	1999	2000	2001	2002	2003		2004
					Q1 Prel.	Proj.	Proj.
National income, prices, and wages							
Nominal GDP (in millions of litai)	42,608	44,698	47,498	50,679	12,213	53,954	58,923
GDP (in millions of U.S. dollars)	10,652	11,174	11,874	13,927	3,793	17,765	19,763
Real GDP growth (year-on-year, in percent)	-1.8	4.0	6.5	6.7	9.4	5.8	6.2
Average CPI (year-on-year change, in percent)	0.8	1.0	1.3	0.3	-1.7	0.0	2.5
End-of-period CPI (year-on-year change, in percent)	0.3	1.5	2.0	-1.0	-1.1	1.7	2.5
GDP deflator (year-on-year change, in percent)	-0.4	0.9	-0.2	0.0	-0.2	0.7	2.9
Average monthly wage (in U.S. dollars)	269	264	266	307	349	...	...
Unemployment rate (in percent) 1/	10.0	12.6	12.9	10.9	9.4	...	...
Saving-investment balance (in percent of GDP)							
Gross national saving	11.9	14.2	16.2	17.4	15.2	17.4	18.2
General government	-3.9	-0.2	0.1	1.7	4.0	1.6	1.2
Non-government	15.9	14.3	16.1	15.6	11.2	15.8	17.0
Gross national investment	23.1	20.2	21.0	22.6	18.9	23.0	24.1
General government	2.2	2.0	1.9	3.1	1.8	3.5	3.7
Non-government	20.9	18.2	19.1	19.5	17.1	19.5	19.5
Foreign saving	11.2	6.0	4.8	5.3	3.7	5.7	5.9
General government fiscal balance (in percent of GDP) 2/	-8.5	-2.8	-2.0	-1.2	3.5	-1.8	-2.6
External sector							
Current account balance							
in percent of GDP	-11.2	-6.0	-4.8	-5.3	-3.7	-5.7	-5.9
in millions of U.S. dollars	-1,194	-675	-574	-734	-139	-1,006	-1,164
Gross official reserves (in millions of U.S. dollars) 3/	1,244	1,344	1,657	2,400	2,874	2,850	2,960
Gross external debt (in percent of GDP) 4/	42.5	43.5	44.4	44.5	38.1	38.7	37.3
Debt service (in percent of exports of GNFS)	18.5	20.9	35.1	39.1	21.2	19.1	18.5
Exchange rate (litai/euro, period average)	4.26	3.69	3.58	3.42	3.45	...	...
Real effective exchange rate (1995=100, "+"=appreciation) 5/	159.8	168.4	165.6	169.8	173.6	...	...
Money and credit							
Reserve money (year-on-year change, in percent)	-4.0	-3.3	8.3	20.8	24.6	4.7	1.3
Broad money (year-on-year change, in percent)	7.7	16.5	21.4	16.9	15.6	13.7	12.7
Private sector credit (year-on-year change, in percent) 6/	13.8	-1.2	15.4	30.4	30.8	28.0	28.0
Money multiplier	2.2	2.6	3.0	2.9	2.8	3.1	3.5
Currency/deposits, in percent	43.9	34.1	29.9	33.9	36.0	33.0	29.0
Foreign currency deposits/ litai deposits, in percent	77.7	83.8	74.8	48.4	44.2	47.0	47.0

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

1/ Registered unemployment, end-of-period. The figure for 2003Q1 refers to June.

2/ The figures for 2003 include the early repurchase of Lithuania's EFF by the BoL in net lending.

3/ Gross official reserves reported here differ from Table 2 due to valuation differences.

4/ External liabilities minus foreign equity investment in Lithuania.

5/ CPI-based, 2000-01 trade-weighted real effective exchange rate against 21 major trading partners.

6/ December 2000 is adjusted for reclassification of LTL 270 million of DMB's claims on private sector, which were removed from balance sheets in July 2000. Also, December 2001 numbers have been adjusted to reflect LTL 785 million of reclassified assets in July 2001.

Table 2a. Lithuania: Balance of Payments, 1999-2003

	1999	2000	2001	2002	2003 Q1	2003 Year Proj.
	(In millions of US dollars, unless otherwise indicated)					
Current account	-1,194	-675	-574	-734	-139	-1,006
Trade balance	-1,405	-1,104	-1,108	-1,337	-90	-1,662
Exports (f.o.b.)	3,147	4,050	4,889	6,031	1,879	8,033
Imports (f.o.b.)	4,551	5,154	5,997	7,368	1,969	9,695
Non-factor services, net	305	380	457	543	78	623
Credits	1,092	1,059	1,157	1,479	320	1,715
Debits	786	679	700	935	242	1,091
Factor income, net	-258	-194	-180	-174	-164	-264
Current transfers, net	163	243	258	233	37	296
Of which: EU accession related	...	...	12	37	...	126
Capital and financial account	1,063	705	779	1049	619	1,292
Capital transfers, net	-3	2	1	57	5	58
Financial account	1,066	702	778	992	614	1,234
Direct investment, net	478	375	439	714	157	550
Assets	-9	-4	-7	-18	-6	0
Liabilities	486	379	446	732	164	550
Portfolio investment, net	511	265	263	-6	459	261
Inflows	513	406	218	100	423	794
Outflows	-2	-141	44	-107	35	-534
Other capital inflows, net	77	63	76	284	-2	423
Inflows	260	23	301	124	35	366
Outflows	-183	40	-225	160	-37	57
Net errors and omissions	-48	127	171	143	-7	0
Financing	179	-157	-359	-458	-473	-286
Fund financing 1/	-17	-26	-34	-35	-57	-79
Change in official reserves (-=increase)	196	-131	-325	-423	-416	-207
Gross official reserves 2/	1,242	1,359	1,669	2,420	2,888	2,627
Gross external debt 3/	4,528	4,856	5,268	6,199	6,776	6,874
Public and publicly guaranteed	2,392	2,364	2,332	2,429	2,844	2,547
Private	2,137	2,493	2,936	3,769	3,932	4,327
Net external debt 4/	2,818	2,948	3,166	3,645	4,093	4,037
Public and publicly guaranteed	2,392	2,364	2,384	2,486	2,903	2,547
Private	426	584	782	1,160	1,190	1,490
Short-term gross external debt						
On an original maturity basis	1,045	1,114	1,558	2,123	2,228	2,166
Of which:						
Excluding trade credit	692	382	689	959	1,019	962
Currency and deposits at banks	189	59	166	219	244	224
Short-term net external debt 5/	-78	-59	278	547	649	644
Debt service 6/	786	1,066	2,123	2,936	466	1,866
Gross amortization	627	854	1,672	2,731	387	1,548
Interest payments	158	212	202	205	79	318
	(In percent of GDP, unless otherwise indicated)					
Current account	-11.2	-6.0	-4.8	-5.3	-3.7	-5.7
Trade balance of goods and services	-10.3	-6.5	-5.5	-5.7	-0.3	-5.8
Trade balance, goods	-13.2	-9.9	-9.3	-9.6	-2.4	-9.4
Trade balance, services	2.9	3.4	3.8	3.9	2.1	3.5
Factor income, net	-2.4	-1.7	-1.5	-1.2	-4.3	-1.5
Current transfers, net	1.5	2.2	2.2	1.7	1.0	1.7
Of which: EU accession related	...	...	0.1	0.3	...	0.7
Financial account	10.0	6.3	6.5	7.1	16.2	6.9
Direct investment, net	4.5	3.4	3.7	5.1	4.2	3.1
Portfolio investment, net	4.8	2.4	2.2	0.0	12.1	1.5
Other investment, net	0.7	0.6	0.6	2.0	0.0	2.4
Gross external debt 3/	42.5	43.5	44.4	44.5	38.1	38.7
Public and publicly guaranteed	22.5	21.2	19.6	17.4	16.0	14.3
Private	20.1	22.3	24.7	27.1	103.7	24.4
Net external debt 4/	26.5	26.4	26.7	26.2	107.9	22.7
Public and publicly guaranteed	22.5	21.2	20.1	17.8	76.5	14.3
Private	4.0	5.2	6.6	8.3	31.4	8.4
Short-term net external debt 5/	-0.7	-0.5	2.3	3.9	3.7	3.6
Debt service, in percent of exports of GNFS 6/	18.5	20.9	35.1	39.1	21.2	19.1
Gross amortization	14.8	16.7	27.7	36.4	17.6	15.9
Interest payments	3.7	4.1	3.3	2.7	3.6	3.3
Memorandum items:						
Nominal GDP (millions of U.S. dollars)	10,652	11,174	11,874	13,927	3,792	17,765
Exports of GNFS (nominal percent change, y-o-y)	-16.4	20.5	18.3	24.2	47.8	29.8
Imports of GNFS (nominal percent change, y-o-y)	-15.9	9.3	14.8	24.0	35.9	29.9
Crude oil price (US$/bll)	18.0	28.2	24.3	25.0	31.3	24.2

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

1/ "-" indicates repurchase; "+" indicates purchase.

2/ The 2003 stocks are calculated based on end-2003 exchange rates. Gross official reserves reported here differ from the monetary survey because reverse repos involving major currencies in both legs are included.

3/ External liabilities minus foreign equity investment.

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

5/ Total short-term liabilities minus total short-term assets, on an original maturity basis.

6/ Debt service comprises interest and repayment on external loans, and interest and repayment on debt securities. The peak in 2001-02 reflects large-scale amortization of dollar-denominated debt immediately before and after the repegging of the litas.

Table 2b. Lithuania: Balance of Payments, 2002-2008

	2002	2003	2004	2005	2006	2007	2008
				Proj.			
	(In millions of U.S. dollars)						
Current account	-734	-1,006	-1,164	-1,182	-1,198	-1,244	-1,294
Trade balance	-1,337	-1,662	-1,924	-2,061	-2,197	-2,265	-2,339
Exports (f.o.b.)	6,031	8,033	8,760	9,594	10,541	11,571	12,664
Imports (f.o.b.)	7,368	9,695	10,684	11,655	12,739	13,836	15,002
Non-factor services, net	543	623	667	681	695	714	731
Credits	1,479	1,715	1,827	1,889	1,952	2,021	2,091
Debits	935	1,091	1,160	1,208	1,257	1,308	1,360
Factor income, net	-174	-264	-410	-468	-527	-583	-643
Current transfers, net	233	296	503	666	831	890	957
Of which: EU accession related	37	126	335	500	667	729	795
Capital and financial account	1,049	1,292	1,313	1,264	1,286	1,397	1,435
Capital transfers, net	57	58	169	253	265	286	309
Financial account	992	1,234	1,144	1,011	1,021	1,111	1,126
Direct investment, net	714	550	550	554	602	659	700
Portfolio investment, net	-6	261	303	176	100	93	67
Inflows	100	794	842	808	367	366	578
Outflows	-107	-534	-539	-632	-267	-274	-511
Other capital inflows, net	284	423	292	281	320	360	359
Inflows	124	366	274	264	307	349	346
Outflows	160	57	18	17	13	11	13
Net errors and omissions	143	0	0	0	0	0	0
Financing	-458	-286	-149	-79	-82	-145	-133
Fund financing 1/	-35	-79	-18	-13	-7	-3	-2
Change in official reserves (-=increase)	-423	-207	-131	-66	-75	-142	-131
Gross official reserves 2/	2,420	2,627	2,758	2,824	2,899	3,041	3,172
Gross external debt 3/	6,199	6,874	7,376	7,952	8,484	9,001	9,523
Public and publicly guaranteed	2,429	2,547	2,620	2,500	2,414	2,300	2,160
Private	3,769	4,327	4,755	5,451	6,070	6,701	7,363
Net external debt 4/	3,645	4,037	4,583	4,994	5,371	5,782	6,168
Public and publicly guaranteed	2,486	2,547	2,620	2,500	2,414	2,300	2,160
Private	1,160	1,490	1,963	2,493	2,957	3,482	4,008
Debt service 5/	2,936	1,866	1,955	2,270	2,006	2,134	2,455
Gross amortization	2,731	1,548	1,579	1,859	1,563	1,664	1,960
Interest payments	205	318	376	411	443	470	494
	(In percent of GDP, unless otherwise indicated)						
Current account	-5.3	-5.7	-5.9	-5.5	-5.2	-5.0	-4.8
Trade balance of goods and services	-5.7	-5.8	-6.4	-6.5	-6.5	-6.2	-5.9
Trade balance, goods	-9.6	-9.4	-9.7	-9.6	-9.5	-9.1	-8.7
Of which:							
Non-energy trade balance	-5.5	-5.2	-5.7	-6.6	-6.6	-6.3	-6.7
Trade balance, services	3.9	3.5	3.4	3.2	3.0	2.9	2.7
Factor income, net	-1.2	-1.5	-2.1	-2.2	-2.3	-2.3	-2.4
Current transfers, net	1.7	1.7	2.5	3.1	3.6	3.6	3.5
Of which: EU accession related	0.3	0.7	1.7	2.3	2.9	2.9	2.9
Financial account	7.1	6.9	5.8	4.7	4.4	4.4	4.2
Direct investment, net	5.1	3.1	2.8	2.6	2.6	2.6	2.6
Portfolio investment, net	0.0	1.5	1.5	0.8	0.4	0.4	0.2
Other investment, net	2.0	2.4	1.5	1.3	1.4	1.4	1.3
Gross external debt 3/	44.5	38.7	37.3	37.2	36.7	36.0	35.2
Public and publicly guaranteed	17.4	14.3	13.3	11.7	10.4	9.2	8.0
Private	27.1	24.4	24.1	25.5	26.2	26.8	27.3
Net external debt 4/	26.2	22.7	23.2	23.4	23.2	23.1	22.8
Public and publicly guaranteed	17.8	14.3	13.3	11.7	10.4	9.2	8.0
Private	8.3	8.4	9.9	11.7	12.8	13.9	14.8
Debt service, in percent of exports of GNFS 5/	39.1	19.1	18.5	19.8	16.1	15.7	16.6
Gross amortization	36.4	15.9	14.9	16.2	12.5	12.2	13.3
Interest payments	2.7	3.3	3.5	3.6	3.5	3.5	3.4
Memorandum items:							
Nominal GDP (millions of U.S. dollars)	13,927	17,765	19,763	21,384	23,137	25,022	27,018
Exports of GNFS (nominal percent change, y-o-y)	24.2	29.8	8.6	8.5	8.8	8.8	8.6
of which: non-energy exports of GNFS	31.1	29.9	12.5	10.9	10.7	10.0	8.2
Exports of goods (percent change, y-o-y)	23.4	33.2	9.0	9.5	9.9	9.8	9.4
Exports of services (percent change, y-o-y)	27.8	15.9	6.6	3.4	3.3	3.5	3.5
Imports of GNFS (nominal percent change, y-o-y)	24.0	29.9	9.8	8.6	8.8	8.2	8.1
Crude oil price (US$/bll) 6/	25.0	24.2	23.5	22.0	21.0	21.0	21.0

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

1/ "-" indicates repurchase; "+" indicates purchase.

2/ The stocks for 2003 and beyond are based on end-2003 exchange rates. Gross official reserves reported here differ from the monetary survey because reverse repos involving major currencies in both legs are included.

3/ External liabilities minus foreign equity investment.

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

5/ Debt service comprises interest and repayment on external loans, and interest and repayment on debt securities. The peak in 2001-02 reflects large-scale amortization of dollar-denominated debt immediately before and after the repegging of the litas.

6/ Oil prices for 2003-08 are based on WEO baseline projection.

Table 3. Lithuania: Summary Monetary Accounts, 1999-2004

	1999	2000	2001	2002	2003		2004
		December			March	Dec.	Dec.
		Actual			Act.	Proj.	Proj.
Monetary Authority							
Net Foreign Assets	4,054	4,607	5,818	7,355	8,874	8,239	8,690
Net Domestic Assets	35	-655	-1,538	-2,187	-3,596	-2,830	-3,209
O/w: Net credit to government	-326	-804	-1,510	-1,972	-3,353	-2,650	-2,914
Credit to banks	30	24	15	16	14	16	16
Credit to private sector	6	6	6	8	8	8	8
Credit to non-bank financial institutions	20	0	0	0	0	0	0
Other items, net	305	120	-50	-238	-264	-204	-319
Reserve Money	4,088	3,953	4,280	5,168	5,278	5,409	5,481
Currency outside the central bank	2,972	2,904	3,263	4,218	4,321	4,644	4,743
Currency outside banks	2,739	2,658	2,920	3,758	3,930	4,183	4,273
Cash in vaults of banks	233	246	343	460	391	460	470
Deposit money banks' deposits	1,109	1,037	1,000	930	931	738	710
Transaction and required reserves accounts in litas	445	621	584	591	573	474	451
Time and special deposits	229	0	0	0	0	0	0
Required reserves in foreign currency	436	416	417	339	358	263	259
Private and non monetary financial institutions	7	12	17	20	26	27	27
Banking Survey							
Net Foreign Assets	3,656	5,368	6,426	7,012	8,073	6,464	5,141
Monetary authority	4,054	4,607	5,818	7,355	8,874	8,239	8,690
Banks and other banking institutions	-398	761	608	-343	-801	-1,775	-3,549
Net Domestic Assets	5,316	5,087	6,265	7,824	6,758	10,397	13,867
Net claims on government 1/	199	569	947	808	-775	642	1,387
Monetary authority 2/	-326	-804	-1,510	-1,972	-3,353	-2,650	-2,914
Banks and other banking institutions 3/	525	1,373	2,456	2,780	2,579	3,292	4,301
Credit to non-financial public enterprises	277	304	253	198	240	221	207
Credit to private sector 3/	5,545	5,209	5,538	7,221	7,554	9,243	11,831
Credit to non-bank financial institutions	468	513	791	980	1,119	1,666	1,815
Other items, net	-1,173	-1,509	-1,265	-1,383	-1,381	-1,375	-1,375
Broad Money	8,972	10,455	12,691	14,836	14,831	16,861	19,007
Currency outside banks	2,739	2,658	2,920	3,758	3,930	4,183	4,273
Deposits	6,233	7,797	9,771	11,078	10,901	12,677	14,734
In national currency	3,509	4,243	5,589	7,465	7,559	8,624	10,023
In foreign currency	2,725	3,554	4,181	3,614	3,341	4,053	4,711
Memorandum items:							
Reserve money (yearly percent change)	-4.0	-3.3	8.3	20.8	24.6	4.7	1.3
Broad money (yearly percent change)	7.7	16.5	21.4	16.9	15.6	13.6	12.7
Private sector credit (yearly percent change)	13.8	-6.1	6.3	30.4	30.8	28.0	28.0
Private sector credit adjusted (yearly percent change) 3/	13.8	-1.2	15.4	...	...	...	...
Money multiplier	2.2	2.6	3.0	2.9	2.8	3.1	3.5
Currency / deposits, in percent	43.9	34.1	29.9	33.9	36.1	33.0	29.0
Foreign currency / litai deposits, in percent	77.7	83.8	74.8	48.4	44.2	47.0	47.0
End-period velocity	4.7	4.3	3.7	3.4	...	3.2	3.1
Gross official reserves, in US$ mln. 4/	1,244	1,344	1,657	2,400	2,874	2,850	2,960
Gross official reserves, in euros	...	...	...	2,302	2,688	2,483	2,597
Reserve coverage (without adjustment)	121.7	136.0	154.9	153.8	175.8	158.5	163.6
GDP (in litas million)	42,608	44,698	47,498	50,679	...	53,954	58,923

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

1/ Excludes local government deposits; includes counterpart funds.

2/ Data for 2001 onwards include Treasury accounts, which were moved from commercial banks to the BoL at end-June, 2001.

3/ December 2000 is adjusted for LTL 270 million of DMB's claims on private sector, which were removed from balance sheets in July 2000. Also, July 2001 numbers have been adjusted by LTL 785 million of reclassified assets.

4/ Gross official reserves for historic data differ from the BOP table because of valuation differences.

Table 4. Lithuania: Summary of Consolidated General Government Operations, 1999-2008

	1999	2000 1/	2001 2/	2002 3/	2003 Q1	2003 Budget	2003	2004	2005 Proj.	2006	2007	2008
						(In millions of litai)						
Revenue and grants	13,687	13,707	14,296	15,445	3,693	16,301	16,348	18,369	20,268	21,973	23,932	25,994
Grants 4/				333	27	432	613	1,381	2,028	2,065	2,229	2,378
Revenue	13,687	13,707	14,296	15,112	3,667	15,870	15,735	16,989	18,239	19,908	21,703	23,616
Tax revenue	12,955	12,841	13,154	13,975	3,372	14,706	14,583	15,908	17,089	18,674	20,381	22,202
Taxes on income and profits	3,971	3,835	3,785	3,875	870	3,861	3,867	4,219	4,611	5,064	5,520	6,056
Payroll tax (social security tax)	2,891	3,194	3,265	3,431	891	3,606	3,622	3,853	4,235	4,600	5,001	5,384
Taxes on goods and services	5,385	5,157	5,474	5,981	1,456	6,504	6,410	7,102	7,483	8,205	9,004	9,853
Other tax revenue	709	655	630	688	155	735	685	734	759	806	856	909
Non-tax Revenue	732	866	1,142	1,137	294	1,163	1,152	1,081	1,151	1,234	1,322	1,415
Expenditure and net lending	17,152	15,011	15,065	15,907	3,547	17,408	17,584	19,925	21,585	23,035	24,570	26,182
Expenditure	16,146	14,711	14,989	16,011	3,707	17,287	17,647	19,840	21,585	23,035	24,570	26,182
Current expenditure 5/	15,190	13,839	14,072	14,417	3,483	15,712	15,764	17,664	19,121	20,516	21,856	23,286
Wages and salaries, excl. contributions to SoDra	3,513	3,450	3,509	3,685	840	3,770	3,768	4,031	4,259	4,502	4,753	5,020
Goods and services	4,425	4,088	4,100	4,244	939	5,005	5,006	5,429	5,641	5,811	5,940	6,155
Transfers to EU	0	0	0	0	0	0	0	518	728	747	792	839
Transfers to households	5,244	5,401	5,586	5,610	1,463	5,959	6,038	6,667	7,418	8,274	9,160	10,077
Subsidies	150	103	81	126	20	162	162	260	224	242	212	180
Interest payments	650	782	781	687	214	711	678	689	801	891	950	965
Savings restitution program	1,207	15	15	65	7	105	112	70	50	50	50	50
Capital expenditure	956	872	918	1,594	224	1,575	1,883	2,176	2,464	2,519	2,714	2,897
Discrepancy	170	-59	163	141	-281	0	-281	0	0	0	0	0
Financial balance	-2,629	-944	-856	-707	266	-986	-1,018	-1,471	-1,317	-1,062	-638	-188
Net lending	1,006	300	76	-104	-160	121	-63	85	0	0	0	0
Lending	1,381	529	455	218	33	248	207	236	80	60	50	50
of which: Mazeikiu Oil Company	800	88	0	0	0	0	0	0	0	0	0	0
Repayments	-375	-230	-378	-322	-194	-127	-270	-151	-80	-60	-50	-50
Fiscal balance (deficit (-)) 6/	-3,635	-1,244	-932	-603	427	-1,107	-955	-1,556	-1,317	-1,062	-638	-188
Financing 5/	3,635	1,244	932	603	-427	1,107	955	1,556	1,317	1,062	638	188
Net domestic	392	-61	153	194	-1,578	198	54	945	1,231	812	538	88
Bank financing	337	-109	105	-215	-1,594	-22	-166	745	1,081	712	488	38
Monetary Authorities	602	-480	-706	-462	-1,381	-861	-678	-264	-230	-166	-100	-103
Commercial Banks	-265	371	812	247	-213	839	512	1,009	1,311	878	588	141
Non-bank financing	55	47	48	410	16	220	220	200	150	100	50	50
Net foreign	2,762	502	281	163	1,148	11	11	211	-214	50	0	0
Privatization proceeds	481	803	498	246	4	898	890	400	300	200	100	100

Table 4. Lithuania: Summary of Consolidated General Government Operations, 1999-2008 (concluded)

	1999	2000 1/	2001 2/	2002 3/	2003 Q1	2003 Budget	2003	2004	2005	2006	2007	2008
							Proj.					
	(In percent of GDP)											
Revenue and grants	32.1	30.7	30.1	30.5	30.2	30.2	30.3	31.2	31.6	31.5	31.6	31.6
Grants 4/	0.0	0.0	0.0	0.7	0.2	0.8	1.1	2.3	3.2	3.0	2.9	2.9
Revenue	32.1	30.7	30.1	29.8	30.0	29.4	29.2	28.8	28.4	28.5	28.6	28.7
Tax revenue	30.4	28.7	27.7	27.6	27.6	27.3	27.0	27.0	26.6	26.8	26.9	27.0
Taxes on income and profits	9.3	8.6	8.0	7.6	7.1	7.2	7.2	7.2	7.2	7.3	7.3	7.4
Payroll tax (social security tax)	6.8	7.1	6.9	6.8	7.3	6.7	6.7	6.5	6.6	6.6	6.6	6.5
Taxes on goods and services	12.6	11.5	11.5	11.8	11.9	12.1	11.9	12.1	11.7	11.8	11.9	12.0
Other tax revenue	1.7	1.5	1.3	1.4	1.3	1.4	1.3	1.2	1.2	1.2	1.1	1.1
Non-tax Revenue	1.7	1.9	2.4	2.2	2.4	2.2	2.1	1.8	1.8	1.8	1.7	1.7
Expenditure and net lending	40.3	33.6	31.7	31.4	29.0	32.3	32.6	33.8	33.6	33.0	32.4	31.8
Expenditure	37.9	32.9	31.6	31.6	30.4	32.0	32.7	33.7	33.6	33.0	32.4	31.8
Current expenditure 5/	35.7	31.0	29.6	28.4	28.5	29.1	29.2	30.0	29.8	29.4	28.8	28.3
Wages and salaries, excl. contributions to SoDra	8.2	7.7	7.4	7.3	6.9	7.0	7.0	6.8	6.6	6.5	6.3	6.1
Goods and services	10.4	9.1	8.6	8.4	7.7	9.3	9.3	9.2	8.8	8.3	7.8	7.5
Transfers to EU	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.9	1.1	1.1	1.0	1.0
Transfers to households	12.3	12.1	11.8	11.1	12.0	11.0	11.2	11.3	11.6	11.9	12.1	12.2
Subsidies	0.4	0.2	0.2	0.2	0.2	0.3	0.3	0.4	0.3	0.3	0.3	0.2
Interest payments	1.5	1.7	1.6	1.4	1.8	1.3	1.3	1.2	1.2	1.3	1.3	1.2
Savings restitution program	2.8	0.0	0.0	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Capital expenditure	2.2	2.0	1.9	3.1	1.8	2.9	3.5	3.7	3.8	3.6	3.6	3.5
Discrepancy	0.4	-0.1	0.3	0.3	-2.3	0.0	-0.5	0.0	0.0	0.0	0.0	0.0
Financial balance	-6.2	-2.1	-1.8	-1.4	2.2	-1.8	-1.9	-2.5	-2.1	-1.5	-0.8	-0.2
Net lending	2.4	0.7	0.2	-0.2	-1.3	0.2	-0.1	0.1	0.0	0.0	0.0	0.0
Lending	3.2	1.2	1.0	0.4	0.3	0.5	0.4	0.4	0.1	0.1	0.1	0.1
of which: Mazeikiu Oil Company	1.9	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments	-0.9	-0.5	-0.8	-0.6	-1.6	-0.2	-0.5	-0.3	-0.1	-0.1	-0.1	-0.1
Fiscal balance (deficit (-)) 6/	-8.5	-2.8	-2.0	-1.2	3.5	-2.1	-1.8	-2.6	-2.1	-1.5	-0.8	-0.2
Financing 5/	8.5	2.8	2.0	1.2	-3.5	2.1	1.8	2.6	2.1	1.5	0.8	0.2
Net domestic	0.9	-0.1	0.3	0.4	-12.9	0.4	0.1	1.6	1.9	1.2	0.7	0.1
Bank financing	0.8	-0.2	0.2	-0.4	-13.1	0.0	-0.3	1.3	1.7	1.0	0.6	0.0
Monetary Authorities	1.4	-1.1	-1.5	-0.9	-11.3	-1.6	-1.3	-0.4	-0.4	-0.2	-0.1	-0.1
Commercial Banks	-0.6	0.8	1.7	0.5	-1.7	1.6	0.9	1.7	2.0	1.3	0.8	0.2
Non-bank financing	0.1	0.1	0.1	0.8	0.1	0.4	0.4	0.3	0.2	0.1	0.1	0.1
Net foreign	6.5	1.1	0.6	0.3	9.4	0.0	0.0	0.4	-0.3	0.1	0.0	0.0
Privatization proceeds	1.1	1.8	1.0	0.5	0.0	1.7	1.6	0.7	0.5	0.3	0.1	0.1
Memorandum Items:												
Primary fiscal balance in percent of GDP	-7.0	-1.0	-0.3	0.2	5.2	-0.7	-0.5	-1.5	-0.8	-0.2	0.4	0.9
Public and publicly guaranteed debt, mln. LTL	12,371	13,195	13,422	13,704	...	13,622	13,632	14,855	15,758	16,442	16,736	16,927
In percent of GDP	29.0	29.5	28.3	27.0	...	25.2	25.3	25.2	24.5	23.6	22.1	20.6
GDP in mln. LTL	42,608	44,698	47,498	50,679	12,213	53,954	53,954	58,923	64,196	69,794	75,852	82,352

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

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

2/ From 2001 onward, fees paid to educational establishments and their spending (LTL128 million) were added to general government operations.

3/ From 2002 onward, fees paid by trucks crossing the borders of the country were added. In addition, following the new organic budget law, revenue of state institutions for provided services was included in municipal budget.

4/ Grants from EU and related expenditures are not included prior to 2002.

5/ For 2001, current expenditure and non-bank financing include LTL72 million of pharmaceutical arrears rescheduled in December 2001 (according to the definition in the SMEP (EBS/01/211)). The entire amount was repaid in March 2002 through a commercial bank loan contracted by the Health Insurance Fund. The latter operations are recorded in 2002Q1 as domestic bank borrowing for LTL 72 million, and amortization to the non-bank sector by the same amount. The terms of the loan include repayments in eight equal tranches of LTL 9 million, starting in 2003, with the final payment due on December 31, 2006.

6/ The early repurchase on January 2, 2003, would reduce the 2003 budgeted deficit by SDR 39.244 million, everything else being equal, as this amount, which was previously on-lent to the monetary authorities, is treated as a repayment in net lending.

Table 5. Lithuania: Indicators of External and Financial Vulnerability, 1999-2003

	1999	2000	2001	2002	Latest	Date
Financial indicators						
State debt (domestic and foreign, in percent of GDP) 1/	28.3	28.5	27.2	26.0	26.6	Q1/2003
Broad money (year-on-year change in percent)	7.7	16.5	21.4	16.9	15.6	Q1/2003
Broad money in percent of gross official reserves	180.6	192.4	190.1	177.4	159.5	Q1/2003
Private sector credit (year-on-year change in percent) 2/	13.8	-1.2	21.4	30.4	30.8	Q1/2003
External indicators						
Current account balance in percent of GDP	-11.2	-6.0	-4.8	-5.3	-3.7	Q1/2003
Exports of GNFS (in millions of U.S. dollars)	4,238	5,109	1,157	7,510	2,200	Q1/2003
Exports of GNFS (year-on-year change in percent)	-16.4	20.6	18.3	24.2	47.8	Q1/2003
Imports of GNFS (year-on-year change in percent)	-15.9	9.3	14.8	24.0	35.9	Q1/2003
Capital and financial account balance in percent of GDP	9.9	6.3	6.5	7.1	16.2	Q1/2003
Gross official reserves (in millions of U.S. dollars) 3/	1,242	1,359	1,669	2,420	2,888	Q1/2003
Gross official reserves/short-term debt 4/	0.65	0.49	0.39	0.52	0.62	Q1/2003
Gross official reserves/reserve money	1.22	1.37	1.56	1.55	1.77	Q1/2003
Gross official reserves in months of imports of GNFS over the following year	2.6	2.4	2.4	2.7	3.1	Q1/2003
Total gross external debt (in millions of U.S. dollars) 5/	4,528	4,856	5,268	6,199	6,776	Q1/2003
in percent of GDP	42.5	43.5	44.4	44.5	38.1	Q1/2003
of which: Public sector debt (in millions of U.S. dollars)	2,392	2,364	2,332	2,429	2,844	Q1/2003
in percent of GDP	22.5	21.2	19.6	17.4	16.0	Q1/2003
of which: Short-term external debt (in millions of U.S. dollars) 4/	1,899	2,786	4,315	4,636	4,636	Q4/2002
in percent of gross international reserves	152.9	205.1	258.5	191.6	191.6	Q4/2002
in percent of GDP	17.8	24.9	36.3	33.3	33.3	Q4/2002
of which: excluding short-term liabilities of the commercial banks 4/	1,018	2,463	3793.0	3893.5	3893.5	Q4/2002
Total net external debt (in millions of U.S. dollars) 6/	2,818	2,948	3,166	3,645	4,093	Q1/2003
in percent of GDP	26.5	26.4	26.7	26.2	23.0	Q1/2003
of which: Public sector debt (in millions of U.S. dollars)	2,392	2,364	2,384	2,486	2,903	Q1/2003
in percent of GDP	22.5	21.2	20.1	17.8	16.3	Q1/2003
Total net external short-term debt (in millions of U.S. dollars) 7/	-206	-59	278	547	649	Q1/2003
in percent of GDP	-0.7	-0.5	2.3	3.9	3.7	Q1/2003
External interest payments in percent of exports GNFS	3.7	4.1	3.3	2.7	3.6	Q1/2003
External amortization payments in percent of exports GNFS	16.5	16.7	27.7	36.4	17.6	Q1/2003
Public and publicly guaranteed debt service as percent of tax revenue	11.5	12.7	10.1	4.1	4.1	Q4/2002
Debt service as percent of exports of GNFS 8/	18.5	20.9	35.1	39.1	21.2	Q4/2002
Real effective exchange rate (year-on-year change in percent, "+" = appreciation) 9/	4.20	6.21	-1.76	3.79	2.56	2/28/2003
Financial market indicators						
Stock market index, end of period 10/	1,089	1,047	855	912	1,154	5/8/2003
Foreign currency debt rating 11/	BBB-	BBB-	BBB-	BBB	BBB+	2/2003
Memorandum item:						
Nominal exchange rate (litai/U.S. dollar, end-of-period)	4.0	4.0	4.0	3.3	3.2	Q1/2003
Nominal exchange rate (litai/euro, end-of-period)	4.0	3.7	3.5	3.5	3.5	Q1/2003

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/ December 2000 is adjusted for LTL 270 million of DMB's claims on private sector, which were removed from balance sheets in July, 2000. Also, July 2001 numbers have been adjusted by LTL 785 million of reclassified assets.

3/ Gross official reserves reported here differ from the monetary table due to valuation differences.

4/ On a remaining maturity basis.

5/ External liabilities minus equity investment in Lithuania.

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

7/ Total short-term liabilities minus total short-term assets, on an original maturity basis.

8/ Debt service comprises interest and repayment on external loans, and interest and repayment on debt securities.

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

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

11/ S&P investment grade rating.

Table 6. Lithuania: Financial Sector Indicators, 1999-2003

(In percent, unless otherwise indicated)

	1999	2000	2001	2002	2003 Mar.
Private sector credit (percentage change, year-on-year) 1/	13.8	-1.2	15.4	30.4	30.8
Loans to private enterprises (in millions)	3,858	3,715	4,549	5,697	5,881
of which: share of foreign currency loans	65.2	70.0	63.8	55.8	56.3
Loans to private enterprises (percentage change, year-on-year)	10.4	-3.7	22.5	25.2	25.8
Share of loans to private enterprises in total lending	65.3	62.8	62.5	63.9	62.7
Loans to individuals	660	573	714	1,216	1,360
of which: share of foreign currency loans	31.6	49.7	45.9	27.7	25.5
Loans to individuals (percentage change, year-on-year)	26.0	-13.2	24.6	70.4	74.7
Share of loans to individuals in total lending	11.2	9.7	9.8	13.6	14.5
Required reserves (in percent of total reserves)	69.8	71.6	83.2	84.8	83.2
Official risk indicators 2/					
Non-performing loans in thousands	663,490	595,613	483,838	461,346	...
Share of non-performing loans in total loans 3/	12.5	11.3	8.2	6.5	5.3
Risk-weighted capital asset ratio (capital over risk-weighted assets) 4/	17.4	16.3	15.7	14.8	14.7
Leverage ratio 5/	11.1	10.2	9.8	10.7	...
Financial sector risk factors of DMB's					
Share of foreign currency loans in total lending	61.6	66.8	60.6	51.1	48.1
Share of foreign currency deposits in total deposits	48.8	49.5	49.1	42.2	40.9
Short-term loans in percent of total loans	41.0	37.9	31.9	27.7	26.5
Demand deposits in percent of total deposits	51.4	48.9	46.5	47.2	47.3
Bank profitability					
Return on Assets	...	0.5	-0.1	1.0	1.6
Return on Equity	...	5.0	-1.1	9.8	14.1
Market assessment					
Spread between VILIBID and VILIBOR 6/ 7/	295.9	233.3	194.0	134.2	99.2
Open position in foreign exchange 8/ 9/	6.0	3.8	1.9	-1.5	10.9
Total loans (in millions)	5,911	5,916	7,284	8,922	9,380
Total deposits (in millions)	7,450	9,176	11,659	13,484	13,419
Average annual interest rate on lita loans to enterprises	12.95	11.82	8.20	5.97	6.10
Average annual interest rate on lita loans to individuals	13.25	12.65	8.48	6.38	7.12

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

1/ December 2000 is adjusted for LTL 270 million of DMB's claims on private sector, which were removed from balance sheets in July, 2000. Also, July 2001 numbers have been adjusted by LTL 785 million of reclassified assets.

2/ 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.

3/ 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).

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

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

6/ Interbank rates; basis points.

7/ 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 VILBOR and the average between the highest and lowest VILIBID.

8/ Open position includes off-balance exposure.

9/ 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.

Table 7. Lithuania: Macroeconomic Framework, 1999-2008

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
							Proj.			
Gross national saving	11.9	14.2	16.2	17.4	17.4	18.2	19.1	19.5	20.0	20.5
General government	-3.9	-0.2	0.1	1.7	1.6	1.2	1.9	2.1	2.7	3.3
Non-government	15.9	14.3	16.1	15.6	15.8	17.0	17.2	17.4	17.3	17.3
Gross national investment	23.1	20.2	21.0	22.6	23.0	24.1	24.7	24.7	25.0	25.3
General government	2.2	2.0	1.9	3.1	3.5	3.7	4.0	3.6	3.6	3.5
Non-government	20.9	18.2	19.1	19.5	19.5	20.4	20.7	21.1	21.4	21.8
Foreign saving 1/	11.2	6.0	4.8	5.3	5.7	5.9	5.5	5.2	5.0	4.8
General government financial balance 2/	-6.2	-2.1	-1.8	-1.4	-1.9	-2.5	-2.1	-1.5	-0.8	-0.2
General government net lending	2.4	0.7	0.2	-0.2	-0.1	0.1	0.0	0.0	0.0	0.0
Consolidated general government fiscal balance 2/	-8.5	-2.8	-2.0	-1.2	-1.8	-2.6	-2.1	-1.5	-0.8	-0.2
Current account balance	-11.2	-6.0	-4.8	-5.3	-5.7	-5.9	-5.5	-5.2	-5.0	-4.8
External debt 3/	42.5	43.5	44.4	44.5	38.7	37.3	37.2	36.7	36.0	35.2
Debt service (in percent of exports of GNFS)	18.5	20.9	35.1	39.1	19.1	18.5	19.8	16.1	15.7	16.6
Nominal GDP (in millions of Litai)	42,608	44,698	47,498	50,679	53,954	58,923	64,196	69,794	75,852	82,352
Real GDP growth (annual percentage change)	-1.8	4.0	6.5	6.7	5.8	6.2	6.2	6.0	6.0	6.0
Average CPI inflation (annual percentage change)	0.8	1.0	1.3	0.3	0.0	2.5	2.5	2.5	2.5	2.5
End-of-period CPI inflation (annual percentage change)	0.3	1.5	2.0	-1.0	1.7	2.5	2.5	2.5	2.5	2.5

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.

LITHUANIA: FUND RELATIONS
(As of April 30, 2003)

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

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	144.20	100.00
Fund holdings of currency	186.02	129.00
Reserve position in Fund	0.02	0.01

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Holdings	0.29	N.A.

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
Extended arrangements	35.36	24.52
Systemic Transformation	6.47	4.49

V. **Latest Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-by	8/30/2001	3/29/2003	86.52	0.00
Stand-by	3/8/2000	6/7/2001	61.80	0.00
EFF	10/24/1994	10/23/1997	134.55	134.55

VI. **Projected Obligations to Fund:**
Under the Repurchase Expectations Assumptions[1]
(SDR Million; based on existing use of resources and present holdings of SDRs):

		Forthcoming			
	2003	2004	2005	2006	2007
Principal	11.64	13.37	9.49	5.18	2.16
Charges/Interest	0.73	0.60	0.32	0.14	
Total	12.37	13.97	9.81	5.32	2.16

VII. **Implementation of HIPC Initiative:**

N/A

[1] Disbursements made after November 28, 2000—with the exception of disbursements of emergency assistance and loans from the Poverty Reduction and Growth Facility—are expected to be repaid on the expectations schedule. Countries may request the IMF Executive Board to make repayments according to the obligations schedule if their external payments position is not strong enough to meet the repayment expectations without undue hardship or risk. Please note : Repayments under the Supplemental Reserve Facility are scheduled to be repaid on the expectations schedule.

VIII. Current Status of Safeguards Assessments:

Under the Fund's safeguards assessment policy, BOL is subject to a full safeguards assessment with respect to the current SBA. A safeguards assessment of the BOL was completed on December 10, 2001. The assessment concluded that an on-site visit was not necessary, but identified certain weaknesses and made appropriate recommendations, as reported in EBS/01/211. BOL has implemented the vast majority of these recommendations under a timetable agreed with the Fund. Staff continues to monitor progress on the implementation of the remaining measure.

IX. Exchange Arrangements:

The currency of Lithuania is the litas. From April 1, 1994 to February 1, 2002, the litas was pegged to the U.S. dollar at LTL 4 per U.S. dollar under a currency board arrangement. Since February 2, 2002 the litas has been pegged to the euro at LTL 3.4528 per euro. Lithuania has accepted the obligations of Article VIII of the Fund's Article of Agreement and maintains an exchange system free of restrictions on the making of payment and transfers for current international transactions.

X. Article IV Consultation:

Lithuania is on the 12-month consultation cycle.

XI. FSAP Participation and ROSCs:

FSAP work program is completed. Data amd fiscal ROSC modules have been recently completed.

XII. Technical Assistance:

The following table summarizes the technical assistance missions provided by the Fund to Lithuania since February 1997.[2]

[2] For technical assistance before 1997, see previous reports.

LITHUANIA: TECHNICAL ASSISTANCE FROM THE FUND, 1997-2002

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
STA	ROSC	Mission	May 8-22, 2002	Department of Statistics, Ministry of Finance, and Bank of Lithuania
FAD	ROSC	Mission	July 10-23, 2002	Ministry of Finance

XIII. Resident Representative:

The resident representative of the Fund in Lithuania is Ms. Zuzana Brixiova, who took up her post in November, 2002.

LITHUANIA: WORLD BANK RELATIONS

Overview of the World Bank Group Involvement

1. Since 1992, the Bank has contributed to Lithuania's transition through investment and adjustment lending, policy dialogue, and analytical advisory assistance. Bank-supported investment projects were designed to help the government implement structural reforms and build institutional and human capacity at sector and local levels. The Bank's analytic work was oriented to analyzing the steps needed to implement Lithuania's structural reform agenda. In addition, the government's overall reform efforts were supported through two structural adjustment loans in 1996 and in 2000 dealing with banking, energy, agriculture, social sectors, private sector development, and budget management issues.

Partnership in Lithuania's Development Strategy

2. Lithuania's leading political, economic, and social objective for the coming years is integration into the European Union, and subsequent improvement in living standards and income convergence. In the pre-accession period Lithuania seeks to maintain rapid and sustainable economic growth and increase competitiveness. A long-term vision of Lithuania is a welfare state that would ensure that benefits of economic growth are spread broadly through the population by supporting knowledge economy, improving public services, and strengthening social policies.

3. A new World Bank Group Country Assistance Strategy (CAS) for the assistance in 2003-2005 is under preparation. The government has indicated its continuing interest in the Bank's strategic advice on medium and long-term issues and its intention to shift to a non-lending relationship for this upcoming period. The government's priority areas for the Bank's support in the next three years are: education and knowledge economy, social and health sector reforms, public administration reform, municipal finance and capacity building, rural development.

4. To date, the Bank has approved 19 projects in the amount of US$490.8 million, of which 10 operations are completed. Of this amount, US$339.1 million has been disbursed and US$64.9 million has been repaid.

5. IFC has supported projects for US$130 million in the financial markets, electronics, chemicals, textile, wood processing, construction materials, and food processing sectors. Current IFC exposure is US$38.6 in four projects as of January, 2003. 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 produced a study on administrative barriers to investment.

Areas of the World Bank supported policy reforms and World Bank-Fund Collaboration:

6. The Fund and the World Bank maintain a collaborative relationship in promoting macroeconomic stability through support of structural reforms. The government's reform program supported by the World Bank's Structural Adjustment Loan (SAL) II was designed to promote a number of synergetic reforms in the areas of budget management, pensions and social assistance, private sector development, energy and agricultural sectors, which helped Lithuania to deal with the consequences of the Russian crisis. The government and the Bank consider that the development objectives of the reform program and of the SAL II were for the most part met. Major accomplishments under the reform program supported by the SAL II included, among others, privatization of two remaining state-owned banks, adoption of new bankruptcy and enterprise restructuring laws, and restructuring of Lithuanian Power company. However, a couple of the reform actions originally agreed under the loan were not fully implemented, in particular those dealing with shifting ownership and managerial control of Lithuanian Gas to a strategic investor, and maintaining restrictions on budgetary expenditures and market regulation of certain agricultural commodities. After an initial one year extension of the loan's closing date, in May 2002 the Government requested that SAL II be closed without release of its second tranche.

7. **Public expenditure management.** The SAL II supported medium-term reforms of public finances and the core budget process. Specific reform areas included government accounting, budgetary support for commercial activities, debt management, control and governance of extra-budgetary arrears, and management of the budget process. Subsequent to the SAL II, technical assistance is being provided to debt management through a World Bank Institutional Development Fund (IDF) grant facility.

8. **Municipal finance.** The World Bank has contributed to analyzing and shaping policies in municipal finance with 1998 policy notes and a report on municipal finance in 2002. The Bank and the Fund are closely monitoring developments in municipal finance. The future agenda includes greater tax and expenditure autonomy at municipal level, improving the selection and financing of municipal capital investments, and strengthening financial reporting of municipal operations.

9. **Financial sector reforms.** The World Bank and the Fund worked closely together to support financial sector reforms. The Bank has maintained close dialogue with the government on banking sector restructuring and provided policy advice in 1998 policy notes and a Macro Financial Vulnerability Study of 1999. Most recently, the Bank and the Fund conducted a joint Financial Sector Assessment Program (FSAP). Post-FSAP technical assistance is being arranged to strengthen accounting and auditing and insurance supervision capacities.

10. **Energy sector.** Lithuanian energy sector reform was supported by SAL programs I and II, which aimed for decentralization of district heating, economic efficiency and privatization of gas and power sectors, the establishment of proper regulatory and

competitive frameworks. The Fund program has emphasized restructuring and subsequent privatization of LPC, and the privatization of LG under its structural reform measures.

11. **Labor markets.** In July 2002, Lithuania passed a new labor market code. The law introduces new forms of flexible employment contracts, liberalizes firing conditions, and foresees the possibility of reducing minimum wages for specific sector or groups. The Bank has provided advice on labor market reform with the analysis presented in Lithuania Country Economic Memorandum (CEM) 2002.

12. **Pensions and social protection.** The Bank worked with the government on pension reform in the context of SAL II, which supported reform measures directed at achieving fiscal balance of the social insurance system in the short term. In 2002, the government approved a law on pension system reform which introduces a voluntary defined contribution second pillar beginning in 2004, in addition to the existing mandatory pay-as-you-go pillar. Preparation for pension reform has been financed through a PHRD grant. Social policy and community services project is helping the Government of Lithuania in providing social security to the population through the institutional development of the Ministry of Social Security and Labor and development, testing, and replication of new community-based social service models that allow feasible and cost-effective social service delivery.

13. **Health sector reform.** Lithuania's health reform is aimed at improving quality and equity in health service provision, strengthening fiscal sustainability of the health system and increasing efficiency in the use of public funds. The Bank has been supporting the government reform program in the health sector through a Health project, which became effective in 2000. Implementation of the project investment component has been satisfactory, but the health policy framework, including health financing issues, has not been adequately addressed in the past. The Bank and the Fund coordinate their advice to the government on identifying measures to improve health financing and health sector management.

14. **Education reform.** The Bank is supporting Lithuania's education improvement program through Education improvement project, approved in 2002. The project seeks to improve student achievement in basic education and to make a more efficient use of the financial, human and physical resources allocated to education, by supporting municipalities in their effort to optimize school network and by improving energy efficiency and space utilization in an initial group of sixty-two targeted schools.

Lithuania: Financial Relations with the World Bank Group
Statement of active IBRD loans (as of May 6, 2003, in millions of original currency)

ID	Project	Currency	Principal	Available	Disbursed	Closing Date
P008539	SOCIAL POLICY AND COMMUNITY SERVICES	USD	3.70	1.03	2.66	15-Jun-03
P035802	MUNICIPAL DEVELOPMENT	EUR	18.89	6.81	12.07	30-Jun-05
P035780	HEALTH	USD	21.24	13.03	8.20	30-Sep-04
P035776	KLAIPEDA PORT	USD	35.36	14.37	20.98	30-Sep-04
P070112	EDUCATION IMPROVEMENT	EUR	29.00	28.68	0.32	30-Jun-06

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 data, though necessary for improving the accuracy and reliability of the 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. Lithuania meets the Special Data Dissemination Standard (SDDS) specifications for coverage, periodicity and timeliness of the data, and for the dissemination of the advance release calendars. Lithuania subscribed to the Special Data Dissemination Standard in May 1996, posted its metadata on the Fund's Dissemination Standards Bulletin Board (DSBB) on the Internet since April 1997, and met SDDS specifications in July 1999. A significant amount of information is now available on various websites through the Internet (see section on Dissemination of Statistics, below).

National accounts

3. The national accounts are compiled by the Department of Statistics (DOS) in accordance with the guidelines of the *European System of Accounts 1995* (*ESA 95*). Quarterly GDP estimates at current and at constant prices are compiled both from the production and expenditure approaches. GDP estimates by production are considered to be more reliable than the corresponding estimates by expenditure, but no statistical discrepancies between these two estimates are shown in the published figures. Good data sources and sound methods are used, in general, for the compilation of the national accounts, but difficulties remain in measuring the economic activity of the informal sector. These latter estimates are compiled at detailed levels of economic activity using fixed coefficients derived from a benchmark survey conducted in 1996. The base year for the fixed price series was changed to 2000 in early 2003.

Price data

4. Since December 1998, the CPI weights have been updated each year. The last update was undertaken in December 2002 and based on the Household Budget Survey (HBS) covering the period October 2001 to September 2002. The monthly CPI is available in the second week following the reference month. The producer price index is calculated according to the chain-linked Laspeyres formula with weights updated every year.

Public finance

5. Data on the central government budget execution are available quarterly, although these data are subject to frequent revisions. The ongoing treasury project is expected to improve fiscal data quality substantially. In January 1999, the Ministry of Finance began publishing data on monthly and quarterly consolidated central government operations and on annual consolidated general government operations, which include the budgetary central government, municipalities and extrabudgetary and social security funds. Further work is needed to clarify the treatment of public health care providers and of EU transactions, and the consolidation procedure for government operations. Regarding classification, amortization of foreign debt in the appropriation to line managers appears to be currently misclassified by the authorities above the line as capital expenditure and would need to be addressed in the Data ROSC update. (The staff reclassifies this item for program monitoring purposes.) Monthly and quarterly data on consolidated central government are not reconciled because they are on different recording bases. In accordance with EU requirements progress was made in adopting ESA 95 accounting standards. However, the maintenance of different budget concepts is still a problem, adversely affecting transparency.

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 scope of the analytical accounts of the banking sector does not fully conform with the recommendations of the IMF's *MFSM* by not including banks in liquidation and two institutions that issue monetary liabilities, recording securities held to maturity by credit institutions at historical values even though they are traded in the secondary market, and not including accrued interest in the valuation of loan portfolios.

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. Hence, in addition to quarterly balance of payments data, the BoL has started publishing monthly balance of payments statistics since January 2002. The monthly data correspond to several key balance of payments components, compiled on the basis of a sample survey covering the public sector, commercial banks, and some nonfinancial private sector institutions. The Data Template on International Reserves and Foreign Currency Liquidity is disseminated according to the operational guidelines and is hyperlinked to the Fund's DSBB.

Dissemination of statistics

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

- Lithuania's metadata for data categories defined by the Special Data Dissemination Standard are posted on the IMF's DSBB (http://dsbb.imf.org);

- 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.

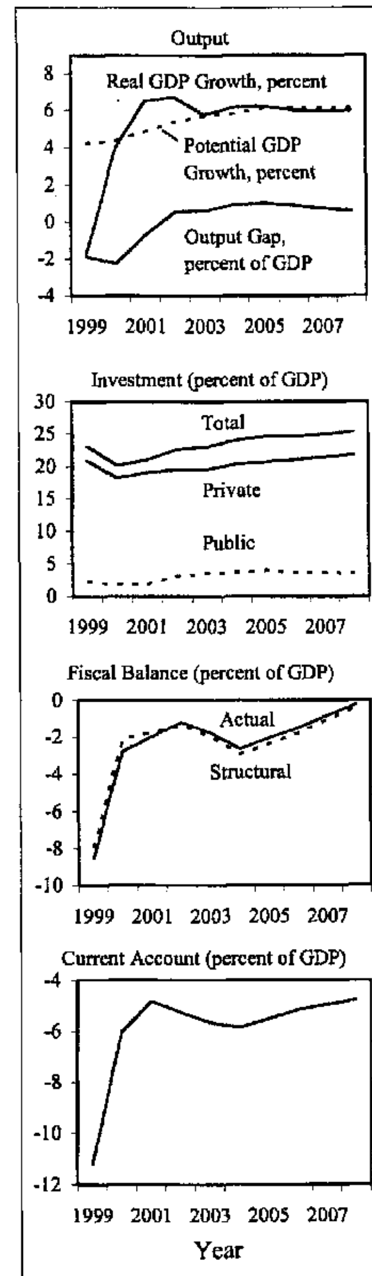
Core Statistical Indicators
(As of July 2, 2003)

	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	07/1/03	4/30/03	05/31/03	5/31/03	5/31/03	5/31/03	5/31/03	4/31/03	Q1/03	3/31/03	Q1/03	3/31/03
Date received	07/2/03	5/30/03	06/15/03	6/15/03	6/24/03	6/14/03	6/14/03	6/30/03	5/31/03	04/28/03	5/30/03	05/28/03
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	C	C	C	C	A 1/, C	C	A 1/, C	A 1/, C	A 1/	A, N 1/	A 1/
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.
Frequency of reporting: M-Monthly, Q-Quarterly, V-irregular in conjunction with staff visits.
Mode of reporting: C-cable or facsimile, E-electronic news reporting, V-staff visits, or O-other.
Confidentiality: (B) for use by the staff and the Executive Board, (C) for unrestricted use.

Medium-Term Outlook



In the process of establishing a market-based economy, Lithuania has undergone major changes since independence in 1991. The Russian crisis in 1998 and the resulting recession in 1999 accelerated the restructuring process by forcing enterprises to modernize and re-orient exports towards the EU and other accession countries. These reforms paid off in the form of high foreign direct investment, rapidly increasing exports, and accelerating economic growth. A driving force has been the eagerness of foreign investors to take advantage of Lithuania's well-educated labor force and low-cost environment. With average monthly wages of about $350 and per capita GDP at less than 20 percent of the EU average (about 35 percent in PPP terms) there is room for a continuation of this process.

In the next few years the economy will see stimulus from further structural reforms, a likely pick-up in growth among advanced economies, and increased financial deepening. Accession to the EU, in May 2004, will also have a positive impact by furthering many of the developments that have contributed to economic growth in recent years, in particular the replacement of Soviet-era laws with more business friendly and EU-compatible versions. The full effect of these steps have not yet been seen, implying a positive impact on growth in the coming years. Grants from the EU have boosted investment in infrastructure and encouraged restructuring of the still highly inefficient agricultural sector, and more will be done on these fronts as grants increase from 0.7 percent of GDP in 2002 to a projected 3.2 percent in 2005 and remain at about 3 percent of GDP annually thereafter. Finally, EU accession will reduce barriers to trade and financial flows with current and prospective EU members, encouraging further integration.

These developments suggest that Lithuania should be able to sustain annual growth rates of about 6 percent over the medium term. This would be somewhat faster than the average growth rate of 4.9 percent since 1995 and closer to the pace of the last few years, reflecting the positive outlook and signs of an increase in growth potential and loosening capacity constraints following increased investment.[1] In fact, annual growth rates of over

[1] Applying a Hodrick-Prescott filter to seasonally adjusted quarterly real GDP from 1995Q1 to 2004Q4 (with projected data for the last seven quarters) shows potential output growing at an average rate of 5 percent during this period, accelerating from 4.2 percent in 1999 to

(continued)

6 percent have now been sustained for some time without inflationary pressures. There is, however, considerable uncertainty attached to these projections, as Lithuania is subject to rapid structural change and highly exposed to developments in partner countries.

The envisioned medium-term scenario involves a continuation of recent trends. EU-related expenditure will cause a temporary widening of the fiscal deficit in 2003-04, after which the movement towards structural balance would resume.[2] Private saving would increase, as higher EU grants can be expected to be spent with some lag and to contribute positively to business profits. In addition, given weak Ricardian equivalence, pension reform and the emergence of private pension funds would boost savings, especially if additional reform steps are taken such as making participation in the second pillar mandatory for younger cohorts. The current account deficit may deteriorate slightly in the near term, due to increased imports of capital goods, but it is subsequently expected to return to near the current level, as higher domestic savings reduce the demand for foreign savings. Foreign direct investment (FDI) is projected to cover about half of the current account deficit, below recent levels. While FDI may well turn out to be higher, there is, however, a risk that the current account deficit could be wider than projected (see Annex III).

The export sector will likely continue to grow, but investors are also expected to be looking to expand the domestic service sector, which will benefit from growing income levels. Unemployment is projected to continue its gradual fall, with an ongoing migration from rural to urban areas. Due to skill mismatches, many of the workers released from the restructured agricultural sector will, however, have difficulties finding alternative employment. Consequently, structural unemployment would remain high so that, while there would be some increase in overall employment, growth would be driven largely by productivity advances. With flexible labor markets, wages are expected to reflect productivity growth—at least in the tradable sector. As a result, competitiveness would remain strong and inflation would remain low, although perhaps ½ a percent higher than in the EU, as productivity growth in the tradable sector may outstrip that in the non-tradable sector (the Balassa-Samuelson effect).

5.4 percent in 2002, and 5.8 percent in 2004. The results are heavily influenced by the 1999 recession—largely the result of a collapse in Russian import demand and thus, arguably, unrelated to Lithuania's output potential—and are also sensitive to choice of the end-period. Excluding 1999, the average historical growth rate over the period was 6 percent.

[2] Based on the above calculation of potential output and assuming that underlying general government revenue moves in line with potential rather than actual GDP, the structural fiscal deficit would be 0.2-0.3 percent of GDP larger than the actual deficit in 2003-04. Assuming that potential GDP grows by 6.1 percent during the following years implies that the projected output gap, and hence the difference between the structural and the actual deficit, would gradually decline. These results, however, should be interpreted with considerable caution due to the uncertainty associated with the estimate of the output gap, raising doubts about the applicability of the concepts of business cycles and structurally balanced budgets to a country subject to such a high degree of structural change.

DEBT SUSTAINABILITY ANALYSIS

Fiscal Sustainability

This section presents the staff's baseline scenario for the Lithuania's public debt for the period through 2008 and the results of public debt sustainability simulations based on shocks to various underlying variables (Table 8). Deviations from the baseline scenario are based on historical averages and/or shocks to these averages (plus/minus two standard deviations). No dynamic feedback effects are considered. The historical averages are based on the period 1997-2002, because the Lithuania's economy went through significant structural changes before 1997, which could distort the analysis.[1] The authorities broadly agreed with this baseline scenario; however, at the time that this scenario was produced, the authorities were still in the process of revising their medium-term projections.

After a two years of economic recovery, the Lithuania's economy suffered setbacks towards the end of 1998 and in 1999, as a result of the impact of the Russian crisis. While real GDP grew by more than 7 percent a year in 1997-98, it shrank by 1.8 percent in 1999. The primary fiscal deficit increased from 3.2 percent of GDP in 1997 to 7 percent in 1999. The ratio of debt to GDP increased from 21.1 percent in 1997 to 29 percent in 1999. Reflecting prudent macroeconomic policies, Lithuania started to recover in 2000. In 2000-2002 strong growth and remarkable fiscal consolidation reduced debt to 27 percent of GDP by the end of the period. Moreover, over this period, the authorities were able to diversify their liabilities, issuing Eurobonds in international capital markets and broadening their domestic debt instruments, and thereby diversifying risks associated with their public debt. Under these circumstances, public debt does not raise significant concern.

Under the baseline scenario, public sector debt is projected to decline gradually to about 21 percent of GDP by 2008, as fiscal consolidation continues and real growth remains strong. The weakening of the fiscal position during 2003-04 is not expected to significantly affect the debt ratio to GDP, which would remain at about 25 percent of GDP for two years before starting to decline again in 2006. Public sector debt as a ratio of revenues would decline from 89 percent in 2002 to 65 percent by the end of the period.

The results of the stress tests in Table 8 suggest that public debt sustainability is particularly sensitive to shocks to the primary fiscal deficit (stress test 4) and to a severe real depreciation (stress test 6), underscoring that fiscal prudence and maintenance of the CBA credibility are key to safeguard public debt sustainability. Of course, the results of stress tests 8-10 show

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[1] As discussed in Annex II, the historical data are heavily influenced by major structural changes and external shocks, also for the more limited period from 1997-2002. In particular, this period was heavily impacted by the Russia crisis, which caused real GDP to decline by 1.8 percent in 1999, and no such shocks are included in the baseline scenario.

that public debt is quite sensitive to shocks to revenue, suggesting that stabilizing the revenue-to-GDP ratio is critical in maintaining public debt sustainability.

External Sustainability

The external sustainability analysis framework follows broadly along the lines of the fiscal sustainability analysis discussed in the previous section. A medium-term baseline projection, incorporating the staff's central forecasts regarding the evolution of a number of key variables, generates a path for the external debt to GDP ratio over the WEO forecast horizon (Table 9). The analysis also considers deviations from this baseline path, reflecting the impact of a number of potential adverse shocks to the historical averages of the variables that mainly drive the external debt dynamics. Once again, to provide a more realistic picture of Lithuania's medium term prospects, these historical averages were based on the 1997-2002 period, rather than the standard 10-year historical period.

The large current account imbalances in the last years of the 1990s resulted in a rapid accumulation of external debt, with this trend exacerbated by the recession that followed Russia's default. As a result, the external debt to GDP ratio peaked at 44½ percent in 2002. On the basis of the baseline scenario (Table 9), this ratio is projected to decline steadily over the medium term, falling below 35 percent by the end of the projection period. The main factors behind this path are continued strong GDP growth, higher EU transfers, and a gradual narrowing of the current account deficit that reflects an increase in domestic savings. As expected, however, interest payments would continue to have an adverse impact on the debt dynamics, on the basis of the WEO projection of euro area interest rates from their current historically low levels.

Turning to the impact of adverse potential shocks on the debt dynamics, the stress tests of Table 9 suggest that Lithuania's external position is somewhat more vulnerable than its fiscal position. Owing to the relatively high initial external debt ratio and the openness of the economy, Lithuania is likely to come against external constraints before fiscal constraints become binding, should such shocks materialize. Table 10 shows that in the event of slowdown in GDP growth or a failure of the current account deficit to narrow the external debt ratio is projected to exceed 70 percent on impact, and to remain above 60 percent through the end of the projection period. This highlights the need for deeper structural reform and a resumption of fiscal adjustment in 2005 to safeguard the external position. The external debt ratio is moderately sensitive to shocks to the interest rate and the exchange rate, with the stress tests pointing to a debt ratio that remains above 50 percent throughout the period under consideration. Finally, the external debt ratio turns out to be least sensitive to negative shocks to inflation, remaining roughly constant at 50 percent.

Table 8. Lithuania: Public Sector Debt Sustainability Framework, 1997-2008
(In percent of GDP, unless otherwise indicated)

	Actual						Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	I. Baseline Medium-Term Projections											
Public sector debt 1/	21.1	22.5	29.0	29.5	28.3	27.0	25.2	25.2	24.5	23.6	22.1	20.6
o/w foreign-currency denominated	13.9	15.5	19.9	23.2	21.2	19.9	16.9	16.6	15.7	13.6	11.3	9.7
Change in public sector debt	-2.1	1.4	6.5	0.5	-1.3	-1.2	-1.8	0.0	-0.7	-1.0	-1.5	-1.5
Identified debt-creating flows (4+7+12)	0.9	0.2	10.0	1.4	0.4	-3.5	-2.4	-0.3	-0.6	-0.8	-1.1	-1.6
Primary deficit	3.2	4.6	7.0	1.0	0.3	-0.2	0.5	1.5	0.8	0.2	-0.4	-0.9
Revenue and grants	32.5	32.2	32.1	30.7	30.1	30.5	30.3	31.2	31.6	31.5	31.6	31.6
Primary (noninterest) expenditure	35.6	36.8	39.1	31.7	30.4	30.3	30.8	32.6	32.4	31.7	31.1	30.6
Automatic debt dynamics 2/	-3.3	-1.3	2.0	0.4	-0.1	-3.8	-1.5	-1.1	-0.8	-0.7	-0.6	-0.6
Contribution from interest rate/growth differential 3/	-3.3	-1.3	2.0	0.4	-0.1	-0.2	-0.4	-1.1	-0.8	-0.7	-0.6	-0.6
Of which contribution from real interest rate	-2.0	0.1	1.6	1.5	1.7	1.6	0.9	0.5	0.6	0.7	0.7	0.6
Of which contribution from real GDP growth	-1.3	-1.4	0.4	-1.1	-1.8	-1.8	-1.3	-1.6	-1.4	-1.4	-1.3	-1.2
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	-3.6	-1.2	0.0	0.0	0.0	0.0	0.0
Denominator = 1+g+π+gπ	1.2	1.1	1.0	1.0	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Other identified debt-creating flows	1.0	-3.1	1.0	0.0	0.2	0.5	-1.3	-0.6	-0.6	-0.4	-0.1	-0.1
Privatization receipts (negative)	-0.3	-5.2	-1.1	-1.8	-1.0	-0.5	-1.7	-0.8	-0.8	-0.4	-0.1	-0.1
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	1.3	2.1	2.1	1.8	1.3	1.0	0.3	0.2	0.2	0.1	0.1	0.1
Residual, including asset changes (2-3)	-3.0	1.2	-3.5	-0.9	-1.7	2.2	0.6	0.2	0.0	-0.2	-0.4	0.1
Public sector debt-to-revenue ratio 1/	65.0	69.9	90.4	96.3	93.9	88.7	83.3	80.9	77.7	74.8	69.9	65.1
Gross financing need 5/	18.0	15.9	26.9	15.3	9.3	8.3	9.3	8.1	6.9	5.2	4.0	4.0
in billions of U.S. dollars	1.7	1.7	2.9	1.7	1.1	1.1	1.5	1.4	1.3	1.1	0.9	1.0
	II. Stress Tests for Public Debt Ratio											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2008							27.2	28.8	30.2	31.6	33.1	35.0
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004							28.1	31.2	30.4	29.2	27.6	25.9
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							27.1	29.4	28.7	27.6	25.9	24.1
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004							33.0	39.4	38.3	36.9	35.0	33.2
5. Combination of 2-4 using one standard deviation shocks							32.4	39.7	35.9	31.9	27.5	23.1
6. One time 30 percent real depreciation in 2003 7/							34.7	34.2	33.2	32.0	30.3	28.6
7. 10 percent of GDP increase in other debt-creating flows in 2003							35.2	34.8	33.8	32.6	30.8	29.1
8. Impact on **debt-to-GDP ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04							26.3	27.9	27.1	26.1	24.5	23.8
8a. Impact on **debt-to-revenue ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04							89.8	95.3	86.5	83.4	78.2	73.2
9. Impact on **debt-to-GDP ratio** if revenue-to-GDP ratio is at historical average in 2003-04							24.2	23.8	23.2	22.3	20.8	19.3
9a. Impact on **debt-to-revenue ratio** if revenue-to-GDP ratio is at historical average in 2003-04							77.2	76.0	74.8	71.1	66.4	61.6
10. Impact on **debt-to-GDP ratio** if revenue-to-GDP ratio is at historicel average minus two the standard deviations of the historical averagein 2003-04							27.3	29.1	28.3	27.2	25.6	24.0
10a. Impact on **debt-to-revenue ratio** if revenue-to-GDP ratio is at historicel average minus two the standard deviations of the historical average in 2003							96.8	99.9	90.1	86.9	81.6	76.5

Historical Statistics for Key Variables (past 6 years)	Historical Average	Standard Deviation	Average 2003-08
Primary deficit	2.7	2.8	0.3
Real GDP growth (in percent)	4.9	3.5	6.0
Nominal interest rate (in percent) 6/	5.8	0.7	5.4
Real interest rate (in percent)	2.6	6.3	3.1
Inflation rate (GDP deflator, in percent)	3.2	5.8	2.4
Revenue to GDP ratio	31.3	1.0	31.3

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 9. Lithuania, External Debt Sustainability Framework, 1997-2008
(In percent of GDP, unless otherwise indicated)

	Actual							Projections				
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	I. Baseline Medium-Term Projections											
External debt	35.1	34.8	42.4	43.0	43.7	44.5	43.2	41.5	39.7	37.9	35.3	33.3
Change in external debt	4.9	-0.3	7.6	0.6	0.6	0.9	-1.4	-1.7	-1.8	-1.8	-2.7	-2.0
Identified external debt-creating flows (4+8+11)	3.3	1.4	7.8	-0.8	-1.9	-1.7	-1.0	-1.5	-1.8	-1.6	-1.3	-0.1
Current account deficit, excluding interest payments	9.9	11.7	10.8	4.1	3.0	3.4	3.6	3.3	2.8	2.7	2.7	2.7
Deficit in balance of goods and services	11.7	13.1	11.4	6.4	5.5	6.9	7.6	7.3	7.4	7.2	7.2	7.2
Exports	54.5	47.0	39.4	45.3	50.2	55.1	57.4	57.1	57.0	56.8	56.7	58.5
Imports	66.1	60.1	50.8	51.7	55.6	62.0	65.0	64.4	64.4	64.0	63.9	65.7
Net non-debt creating capital inflows (negative)	-2.7	-8.1	-4.8	-4.4	-4.2	-4.7	-3.8	-3.4	-3.2	-2.9	-2.7	-2.5
Net foreign direct investment, equity	2.7	8.1	4.9	3.4	3.8	4.3	3.4	3.1	2.8	2.6	2.4	2.3
Net portfolio investment,equity	0.0	0.0	0.0	1.1	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.2
Automatic debt dynamics 1/	-3.9	-2.2	1.8	-0.5	-0.7	-0.4	-0.9	-1.4	-1.5	-1.4	-1.4	-0.3
Contribution from nominal interest rate	1.5	1.6	1.5	1.9	1.8	2.0	2.2	2.1	2.0	1.9	1.8	1.7
Contribution from real GDP growth	-1.8	-1.6	1.4	-1.5	-2.4	-2.4	-2.2	-2.3	-2.2	-2.1	-2.1	-2.0
Contribution from price and exchange rate changes 2/	-3.5	-2.2	-1.1	-0.8	-0.1	0.1	-0.8	-1.2	-1.2	-1.2	-1.1	0.0
Residual, incl. change in gross foreign assets (2-3)	1.6	-1.7	-0.1	1.4	2.6	2.5	-0.4	-0.1	0.0	-0.2	-1.4	-1.9
External debt-to-exports ratio (in percent)	64.5	74.0	107.7	95.1	87.1	80.8	75.2	72.7	69.6	66.8	62.2	56.9
Gross external financing need (in billions of US dollars) 3/	2.3	3.2	3.0	1.7	1.7	1.9	2.1	2.1	2.1	2.3	2.5	2.6
in percent of GDP	24.5	29.3	28.0	15.4	14.1	15.4	15.7	14.5	13.2	13.1	12.9	12.7
	II. Stress Tests for External Debt Ratio											
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2008							45.7	47.0	48.5	49.7	49.7	49.2
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004							51.6	59.2	56.8	54.4	51.1	49.0
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							58.9	77.5	74.4	71.4	67.5	65.3
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004							46.8	49.2	47.1	45.1	42.2	40.1
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004							58.8	72.4	69.5	66.7	63.0	60.8
6. Combination of 2-5 using one standard deviation shocks							54.4	65.4	62.8	60.2	56.7	54.6
7. One time 30 percent nominal depreciation in 2003							64.4	62.0	59.5	57.0	53.6	51.5

Historical Statistics for Key Variables (past 6 years)	Historical Average	Standard Deviation	Average 2003-08
Current account deficit, excluding interest payments	7.2	4.0	3.1
Net non-debt creating capital inflows	4.8	1.8	3.4
Nominal external interest rate (in percent)	4.9	0.5	5.1
Real GDP growth (in percent)	4.0	4.0	5.8
GDP deflator in US dollars (change in percent)	4.2	5.0	2.3

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LITHUANIA

Staff Report for the 2003 Article IV Consultation—Supplementary Information on Financial Sector Developments

Prepared by the Monetary and Financial Systems and the European II Departments

Approved by Tomás J. T. Baliño and José Fajgenbaum

July 28, 2003

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I. Introduction

1. The mission[1] conducted a follow-up assessment of issues examined during the November 2001 mission of the Financial Sector Assessment Program (FSAP). This report reviews the developments in the financial markets, including the foreign exchange, money and securities markets; provides an overview of conditions in the banking system; and presents a factual update of progress in implementing recommendations put forth in the assessments of the Basel Core Principles for Effective Banking Supervision and of the International Association of Insurance Supervisors Insurance Core Principles.

2. The mission met with the authorities at the Bank of Lithuania, the Ministry of Finance, commercial banks and the Commercial Bankers' Association, and the National Stock Exchange of Lithuania. The mission would like to thank all of its counterparts, and in particular the officials of the Bank of Lithuania and the Ministry of Finance, for their excellent cooperation and hospitality.

II. Summary of Findings

3. **With the privatizations of the banking sector finalized, the banking system has exhibited steady strengthening since the FSAP.** The Bank of Lithuania's supervisory oversight and careful monitoring of loan quality have contributed to the increased soundness of banking prudential indicators, well-capitalized banks, improved bank profitability, and falling non-performing loans.

4. **Measures recommended by the FSAP report as part of the Basel Core Principles (BCP) for Effective Banking Supervision have been largely implemented in the new draft Law on Banks**. The draft Law addresses concerns noted in the BCP assessment, incorporating new powers as well as further strengthening existing capacities of the BoL in its supervisory and regulatory capacity. The draft Law incorporates measures to enhance the BoL's ability to detect and prevent money laundering and financial crimes by strengthening inspections, bank reporting requirements, and cooperative efforts amongst financial and law enforcements agencies.

5. **The mission welcomed the discontinuation of the government's savings securities program.** Originally intended to attract the public into the capital markets, it has not served to deepen financial markets, and with past high, administered rates of interest, has instead detracted from savings in the banking system. The cost to the government in terms of commissions, above-market effective returns on securities and the risk of sudden encashment made this an expensive means of raising financing and deepening capital markets.

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[1] The mission visited Vilnius from June 3 – 12, 2002 and included Ms. Jodi Scarlata (MFD) as a member of the European II Article IV Consultation mission. Ms. Zuzana Brixiova, IMF Resident Representative, and her staff assisted in the work of the mission.

6. **Financial markets in Lithuania have continued their expansion and development while remaining stable.** The foreign exchange market has grown considerably since the FSAP and is the most well-developed of the markets, characterized by high turnover, expanding competition and narrowing spreads. The money market remains the weaker of the markets, with limited trading among a few major banks. The Treasury bill market is growing in both breadth of participants and instrument maturities; however, activity is predominantly centered in the primary market, with relatively low and flat secondary market trading during the last two years.

7. **Based on recommendations made in the assessment of the International Association of Insurance Supervisors (IAIS) Insurance Core Principles, a new draft Law on Insurance indicates that most of the concerns put forth in the IAIS assessment have been addressed; however, vulnerabilities remain in the insurance supervisory framework and in the supervision of pension funds.** The draft Law considerably limits the financial independence SISA. The salary structure and employment of staff will remain determined by the Law on Civil Servants and, as a result, there is concern that salaries are not sufficient to retain highly skilled staff, such as actuaries, and the risk of high turnover remains. This is particularly worrisome in light of the added responsibility of pension fund supervision that will be given to SISA. In the interim period before pension funds are major institutions in the financial market, attention should be given to strengthening the insurance supervisory and legislative infrastructure—including issues arising from pension fund supervision— to ensure the sound oversight of both financial sectors.

III. BANKING SECTOR

A. Background

8. **The banking sector remains the largest component of Lithuania's financial sector,** with ten banks and four foreign branch banks. Total bank assets were about 34 percent of GDP as of end-2002. The banking system remains concentrated, although the degree of concentration is declining. The three largest banks held almost 73 percent of assets and almost 79 percent of deposits, as of April 1, 2003, down from 81 percent and 85 percent, respectively, in January 2001. Foreign ownership in the banking system comprised 88 percent of share capital as of April 1, 2003.

9. **Lending activity is strongest in the economic areas of manufacturing and wholesale and retail trade,** comprising 25 percent and 23.6 percent of total loans, respectively, during 2002, and retaining approximately the same shares through March 2003 (Table 1). The maturity structure of bank lending has also deepened, as the proportion of long-term loans (more than one year) has increased from 51 percent of loans granted, as of January 1999, to about 75 percent as of May 2003. Some banks estimate that 60 percent of loans exceed a maturity of three years; corporate loans of seven years (and a few to 10-12 years) and 25 to 40 year mortgages are now being offered.

10. **The Lithuanian banking system has exhibited a steady increase in confidence in the litas.** Banking system[2] assets held in litas have increased from 50.2 to 56.6 percent during January 2002-May 2003, while liabilities have increase from 55 to 64.7 percent over the same period. At the same time, and as noted above, the weakening of the dollar resulted in a move out of dollars and into Euros and during the same period, banking system assets denominated in euros rose from 12.5 to 26.5 percent, while the dollar's share declined from 36.4 to 15.7 percent. Banking system liabilities experienced a similar but more moderate trend, with Euro liabilities increasing from 11.4 to 16.1 percent and dollar liabilities declining from 32.7 to 18 percent.

B. Banking Supervision

11. **Since the FSAP assessment, banking system soundness has continued to improve.** Regulatory Tier-I capital to risk weighted assets has increased steadily over recent years and the capital adequacy ratio (CAR) remains well above the 10 percent requirement set by the BoL (Table 1).[3] Asset quality has also improved, as reflected in a decline in NPLs from 8.2 percent of total loans at the time of the FSAP to 5.3 percent as of March 2003, while the ratio of NPLs net of provisions to total capital declined from 25 to 19.5 percent over the same period. The difference between gross asset and liability positions in derivatives has widened since 2001 reflecting increased relations with foreign counterparts and parent banks overseas and the growing popularity of derivatives, particularly swaps.[4] Banks' net open position in foreign exchange to total capital has increased with the growing development and usage of the foreign exchange market, but remains well below the BoL's 25 percent aggregate net open currency position limit. The mission recommended that these positions be supervised regularly by the BoL as the market progresses.

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[2] Excluding foreign bank branches.

[3] In 2001, the calculation methodology for the CAR changed to correspond with the introduction of the Capital Adequacy Directive (CAD) II, which incorporated market risk. As a result of the change in the calculation, there was an increase in the number of banks with a CAR of less than 15 percent in 2001.

[4] The CISD noted that this results from maturities differing over the reporting periods; data were not available on individual banks' maturities breakdown, but the divergence was known to CISD and was not considered of concern.

Table 1. Lithuania: Financial Soundness Indicators for the Banking Sector, 1998-2003
(In percent, unless otherwise indicated)

	Dec-98	Dec-99	Dec-00	Dec-01	Dec-02	Mar-03
Capital Adequacy						
Regulatory Tier-1 capital / risk-weighted assets	19.0	13.0	12.7	12.7	14.7	15.2
Total regulatory capital / risk-weighted assets (CAR)	23.8	17.4	16.3	15.6	14.8	14.7
Total regulatory capital / total assets	13.9	9.9	9.2	9.4	9.9	10.2
Number of banks with CAR less than 15 %	0	1	1	4	6	3
Asset Quality						
Sectoral distribution of loans to total loans *						
Manufacturing	23.9	30.2	28.4	25.6	25.0	25.6
Wholesale and retail trade	22.1	23.0	23.8	24.3	23.6	23.7
State administration and defense, obligatory social security	...	6.5	9.9	8.7	5.0	4.3
Financial intermediation	8.3	7.4	7.9	10.9	12.4	14.4
Electricity, gas, and water supply	6.3	11.5	8.6	8.3	8.5	7.1
Transport, communication, hotels, and restaurants	5.9	8.4	7.5	8.2	7.7	7.5
Real estate and leasing	3.0	2.7	5.5	6.2	8.0	7.5
Construction	2.7	3.5	3.5	3.3	4.6	4.8
Agriculture, hunting, forestry, and fishing	4.8	4.5	2.2	1.8	2.5	2.4
Geographical distribution of loans to total loans						
Group A countries 1/	...	...	99.38	99.99	99.90	99.97
Group B and C countries 1/	...	...	0.62	0.01	0.10	0.03
Foreign exchange loans to total loans	52.2	59.2	65.1	59.3	48.4	48.1
Foreign exchange liabilities to total liabilities	45.4	52.9	52.6	50.1	41.2	40.3
Nonperforming loans to total gross loans	12.9	12.5	11.3	8.2	6.5	5.3
Nonperforming loans net of provisions to total capital	22.8	38.8	34.0	25.0	24.6	19.5
Loan loss specific provisions/total loans	6.15	4.67	3.91	2.82	1.2	1.1
Large exposures to capital	...	...	106.6	196.7	194.7	190.5
Number of banks with credit exposures above 25 percent of capital	2	2	0	0	0	0
Connected lending / total capital	3.1	2.5	2.4	2.8	2.1	2.4
Gross asset position in derivatives to capital	57.7	27.0	123.2	144.7	175.4	159.0
Gross liability position in derivatives to capital	55.6	25.9	126.3	144.3	168.6	146.4
Spread** between highest and lowest interbank rate LTL	1.4	2.2	1.6	1.3	1.2	1.3
Spread** between highest and lowest interbank rate FX 2/	0.2	0.4	0.1	0.0	0.1	0.1
Spread between reference lending and deposit rates LTL	6.0	8.1	8.1	5.4	5.0	4.7
Spread between reference lending and deposit rates FX	6.0	7.1	6.2	4.0	3.9	3.2
Trading and foreign exchange gains / total income	9.4	4.6	6.9	4.9	6.8	7.0
Customer deposits / total non-interbank loans	128.7	124.3	152.8	156.9	145.1	136.1
Total loans / total assets	44.16	48.84	41.87	41.06	44.8	48.0
Management						
Expenses to revenues	91.8	98.0	95.3	101.1	87.9	79.5
Personnel expenses / non-interest expenses	42.2	36.5	37.1	35.9	39.0	42.0
Earnings per employee (thousands of Litas)	115.9	138.3	154.8	150.3	167.0	40.9
Earnings and Profitability						
Return on average assets	0.9	0.2	0.5	-0.1	1.0	1.6
Return on average equity	11.9	1.3	5.0	-1.2	9.8	14.1
Interest margin to gross income	34.9	41.7	36.8	35.9	38.0	37.6
Noninterest expenses to gross income	66.7	69.1	62.5	71.6	68.4	61.8
Liquidity						
Liquid assets to total assets	36.6	27.5	32.3	33.3	30.2	27.1
Liquid assets to short-term liabilities	51.0	37.6	41.0	39.9	36.3	32.7
Funding volatility ratio (volat.liab.-liq. assets/illiquid assets)	40.9	47.1	49.6	54.9	59.6	57.5
Demand deposits to total liabilities	44.0	38.1	38.2	40.5	43.1	42.8
Sensitivity to Market Risk						
Net open position in foreign exchange / total capital	-3.8	6.0	3.8	1.9	-1.5	10.9
Net open position in equities / total capital	13.6	18.6	15.6	13.9	12.3	11.7

Source: The Bank of Lithuania, staff calculations.
1/ Group A (lower risk) includes in general countries with a rating of at least Aa3 by Moody's Investor Service or at least AA by Standard & Poor's, FitchIBCA, or Thomson BankWatch. Groups B (medium risk) and C (high risk) include other countries.
2/ Only transactions in euros and U.S. dollars.
* only residents
** average daily spread for o/n interbank transactions among residents, per year (quarter)

12. **Following the bank privatizations and the necessary restructuring of portfolios, banks' profitability improved modestly during 2002** and into the first three months of 2003, as reflected in the return on average assets, while return on equity grew more strongly. Banks are liquid, with assets to current liabilities remaining above the 30 percent BoL requirement. The decline in liquidity over recent years reflects the fact that when commercial banks were preparing for privatization, they were limited to more liquid investments. In the early period under the new ownership, banks' lending practices were conservative. However, there has since been an increase in lending activity with the strong expansion in the economy. This change in liquidity is reflected in the growth of loans as a share of total assets and the corresponding decline in the ratio of liquid assets to total assets. The mission encouraged the BoL to maintain rigorous banking supervision in order to ensure financial sector stability, particularly in view of the rapid growth of money and credit.

13. **Banking sector interests have also been expanding as banks have acquired ownership of insurance companies,** with two of the three largest banks operating in the insurance sector. At present, there is room for some consolidation in the insurance sector—too many small firms to remain profitable given the size of the market. However, such a consolidation is not viewed by the BoL as a potential source of instability to the banks, as insurance companies represent a small proportion of banking interests

C. Basel Core Principles

14. **Since the assessment of the Basel Core Principles (BCP) conducted as part of November 2001 FSAP, the Bank of Lithuania has implemented recommendations set forth in the FSAP assessment** (Box 1). A draft Law on Banks will be submitted by the government to the parliament in the fall of 2003 that addresses the concerns noted in the BCP assessment and further strengthens the Credit Institutions Supervision Department (CISD) in its supervisory and regulatory capacity.[5] The BoL has also undergone a Peer Review by the European Union of its banking supervisory capacities. Issues raised by the BCP assessment that remain are minor, but comply with EU directives. In addition, the CISD formulated an action plan for the banking sector as part of the Review.

15. **The BoL has incorporated new banking supervisory and regulatory powers into the draft Law on the Banks, as well as strengthened previously established capacities.** The draft Law includes additional requirements in granting licenses; regulating the establishment and activities of credit institutions through establishing prudential requirements and the accumulation of the information necessary to effectively supervise credit institutions; strengthening the legal capacities of the BoL in responding to bank distress; and introducing mandatory stress testing as part of financial statements for 2002. New regulations enable banks to develop their own rules on assessment and classification of doubtful assets and the formation of specific provisions, and banks now required submit to the BoL their bank rules, collateral valuations rules, and doubtful assets classification and

[5] A complete translation of the draft Law was not available to the mission.

Box. 1 Implementation of Recommendations from the Basel Core Principles Assessment (FSAP)

CP 1 Objectives, Autonomy, Powers and Resources

The Draft Law on Banks (Articles 43, 44 and 46) includes more stringent requirements for: granting licenses, including additional background information on applicants; regulating the establishment and activities of credit institutions through more rigorous criteria on bank insolvency and the accumulation of the information necessary for effective supervision; strengthening the legal capacities of the BoL in responding to bank distress; the introduction of mandatory stress testing as part of financial statements for 2002; and the application of measures for those institutions with compliance failures. Art. 65 of the Draft Law provides for legal protection of BoL staff functioning in accordance with legal acts.

CP 3 Licensing Criteria

The Draft Law widens the statutory criteria for bank license applications, including requirements on internal controls, accounting systems, risk management system, security measures, operational plans, as well as on minimum capital and bank shareholders.

CP 4 Ownership

Art. 28 of the Draft Law gives the BoL the right to apply to the courts with the requirement that a shareholder sell his holdings to a person or persons as specified by the supervisory authority when the bank shareholder does not meet requirements as set out in law. The coercive sale of bank shares is regulated by the Civil Code.

CP 5 Investment Criteria

Art. 32 of the Law on Financial Institutions, adopted on September 10, 2002 (and in Draft Law Art. 25), sets forth requirements on a financial institution for evaluating and limiting risk arising from the investments into the capital or voting rights of other companies. In addition, Art. 7 sets criteria for the qualified portions of the authorized capital and/or voting rights of a financial institution. However, the BoL does not have the power to deny a bank's acquisition of another financial institution. The BoL's view is that its supervisory criteria, including those on bank ownership, provide sufficient safeguards.

CP 8 Loan Evaluation and Loan Loss Provisioning

On March 20, 2003, the BoL approved new general regulations enabling banks to develop their own rules on assessment and classification of doubtful assets and the formation of specific provisions. Minimum requirements are established in the Bank Rules on Assessment and Classification of Doubtful Assets. The new resolutions come into effect as of December 31, 2003, and by October 15, 2003, banks must furnish the BoL with bank rules, collateral valuations rules, and doubtful assets classification and specific provisions formations of the last reporting period, both according to the methods applied by the bank and according to the new methods developed by the bank.

Art. 31 of the Draft Law provides that the bank supervisory council must ensure an effective internal control system, including developing the monitoring and control system used for identifying, measuring and controlling risks; setting risk ceilings; and maintaining the clear assignment and performance of rights and responsibilities of staff. The BoL is currently drafting guidelines for operational risk management for bank boards.

CP 9 Large Exposure Limits

Resolution of the Board of the BoL No.91 On Maximum and Large Exposure Requirements (adopted July 4, 2002) reduced the maturity for interbank loans, for the purpose of large exposure limits, to 14 calendar days.

CP 10 Connected Lending

The Draft Law (Art. 51) has strengthened the assessment of risks of connected lending by requiring ceilings set by the supervisory council and requisite approval by the council of the conditions and procedures for such lending. As part of consolidated supervision of a financial group, Art. 52 permits the supervisory authority to set limits on connected lending to the parent company of the bank and companies controlled by the parent.

CP 12 Market Risks

The Draft Law on Banks provides that the BoL has the right to define individual bank limit requirements for a bank's net open currency positions.

CP 13 Other Risks
The BoL requires stress testing by banks including interest rate gap calculations and the effects of operational and liquidity reduction risks and has approved the General Provisions for the Monitoring and Management of the Risk Involved in Electronic Banking, requiring banks to evaluate the monitoring and management of risks stemming from electronic banking services. Since September 2002, CISD examinations include the inspection of risk management in information technologies and electronic banking. The obligatory internal control system is regulated by Art 35 of the Draft Law, and fines may be imposed on a bank or its senior managers for violations.

CP15 Money Laundering
BoL examiners have participated in seminars abroad on anti-money laundering (AML) and Art. 4 of the Law on the Prevention of Money Laundering (March 28, 2002) states that the BoL issues methodological recommendations to banks on their AML responsibilities. CISD's amended inspection manual provides AML measures, including a separate evaluation of a bank's AML procedures and an evaluation of the bank's customer identification capacity, i.e., "know your customer" principle.

The BoL participates in a working group on the prevention of money laundering that includes 14 financial, legal and law enforcement agencies and the Financial Crime Investigation Authority ensures day-to-day coordination among the members in accordance with the AML Law (Art. 6).

CP 20 Consolidated Supervision
The Law on Financial Institutions (2002) provides that if at least one of the financial institutions in a financial group is a credit institution, consolidated supervision is undertaken of the whole group with the right to receive all necessary information. The BoL may establish different capital adequacy ratios for the separate institutions in accordance with capital and risk distribution in the group. The Draft Law grants the BoL the right to inspect subsidiaries or controlling holding companies engaged in mixed activities if the whole financial group is subject to BoL supervision. The Regulations on Drawing up Consolidated Statements and Consolidated Supervision have been revised accordingly.

CP 21 Accounting Standards
The Key Principles on Financial Accounting and Reporting Policy of Credit Institutions were supplemented, requiring credit institutions to follow IAS and provide accounting and reporting policies regarding assets, property and liabilities, fair value methods, risk assessment and hedging methods, etc. Bank financial statements for 2002 were compiled in observance with IAS 39.

In February 2002, the resolution On Minimum Requirements for Public Information set minimum criteria on the disclosure of information and on the quality, content and frequency of its publication. At least quarterly (or after year-end), banks must disclose data of the parent bank and the consolidated bank group including the balance sheet, profit and loss statement, and key indicators of asset quality and profitability.

CP 22 Remedial Measures
The Draft Law (Art. 73) allows the BoL to apply enforcement measures to licensed banks and foreign bank branches, including penalties on the board, administration and managers of foreign bank branches.

CPs 24 and 25 Host Country Supervision and Supervision over Foreign Banks' Establishments
The conditions for the application of penalties on banks are set forth in the Draft Law (Art.78) and are determined based on the nature of the violation. The BoL has signed cooperation agreements with all foreign supervisory agencies of banks operating in Lithuania and has conducted joint inspections with Polish, Estonian and Latvian supervisory authorities. Cooperation agreements have been signed with authorities in Sweden, Poland, Belarus, Russia, Finland, Latvia, Estonia and Germany and permit joint bank supervision and exchange of information.

specific provisions formations of the last reporting period by October 15, 2003. From September 2002, CISD bank examinations include the inspection of risk management in information technologies and electronic banking as well as the internal control system and operational risk management. Transparency has been enhanced through stricter publication requirements of credit institutions, in both quality and frequency of their publications.

16. **The BoL has also strengthened its ability to detect and prevent money laundering and financial crimes by strengthening inspections, bank reporting requirements, and cooperative efforts amongst financial and law enforcement agencies.** The Law on the Prevention of Money Laundering (March 28, 2002) empowers the BoL to issue methodological recommendations to banks on their anti-money laundering (AML) responsibilities and requires credit and financial institutions to appoint persons responsible for the implementation of measures for the prevention of money laundering and to liaise with the Financial Crimes Investigation Authority. CISD has amended its inspection manual to include a separate evaluation of a bank's AML procedures, on-site inspection of the documentation for the opening of customers' accounts, and an evaluation of the bank's internal control procedures to ensure the proper customer identification capacity, i.e., "know your customer" principle. The BoL participates in a domestic working group on the prevention of money laundering, which includes 14 financial, legal and law enforcement agencies. The Financial Crimes Investigation Authority ensures day-to-day coordination with the members in accordance with the AML Law (Art. 6). BoL examiners have also participated in seminars and conferences abroad on anti-money laundering procedures.

IV. Securities Markets

A. Treasury Bill Auctions

17. **Primary auctions of government securities are conducted weekly and have been progressively expanding as the government has extended the maturity structure of its borrowing.** Government securities are offered in maturities of 6- and 12-month bills, and three, five, seven and 10 year bonds, of which the latter two maturities are the least frequently auctioned. Not all maturities are auctioned weekly and eligible maturities are rotated on a predetermined schedule made available to market participants. Participation is strongest in the shorter maturities. While all maturities tend to be oversubscribed, with maturities of up to three years significantly so, the 12-month bills see the most competition as exhibited in the tightest spreads across bids. There are six primary dealers—one brokerage firm and five commercial banks—that serve the retail market and stand ready to buy and sell across all maturities.

18. **Commercial banks are the dominant purchasers, comprising 64 percent of the total market as of March 31, 2003, with insurance companies holding the next largest portion**, at a significantly lower 17 percent share. Insurance companies are becoming an increasing presence in the market, especially in the longer maturities, holding 37 percent of the longest maturities and banks holding 31 percent. The outstanding stock of government securities stood at LTL 2.4 billion at end-2002, sold almost entirely to residents. Thirty-five

percent of outstanding securities will mature in two to five years, while 17 percent will mature in one to two years.

19. **Despite the declining trend in nominal interest rates for treasury bills, interest rate movements since the February 2003 issue of 10-year treasury bonds indicate an increasing spread over base currency instruments** of approximately 180 basis points, well in excess of the 60 to 70 basis points accounting for credit risk.[6] One factor behind this trend seems to reflect the weaker demand for such a long maturity—banks' portfolios do not match such a maturity structure and these bonds are less attractive. Conversely, insurance companies are the predominant purchasers of these long term bonds, reflecting the complementarity of their activities and long-term investments. In addition, some players base their bids on the results in the previous auction without gauging interest rate trends in the broader overseas market. As a result, competition does not yet seem significant enough to drive yields down and, based on the recent bidding, market players are unlikely to do it voluntarily. The government's need to offer 10 year bonds to meet EU accession criteria is a factor that plays to the advantage of market players. This is of particular concern as the government can raise funds more cheaply abroad in the Eurobond market that it can at home, of which the domestic market should be made aware.

20. **The mission believes that if the government were to utilize its primary dealer system to signal to the market that yields for 10-year bonds will gradually decline**, these treasury bonds would still be an attractive option for purchase, in light of the limited alternative domestic instruments in which to invest. In this manner, the government would be able to ease its financing costs while continuing to deepen the domestic debt market. As banks' portfolios lengthen in maturity, insurance companies expand their presence in the market and the eventual entry of pension funds, it would be expected to see further depth and competition in the longer term markets.

21. **At present, final investors dominate the securities market and as a result, secondary market activity is small.** The average number of weekly trades has remained unchanged over the last two years at 27-28 trades per week and an average weekly turnover of LTL 19 million in 2001, rising to LTL 26 million in 2002. At end-2002, total turnover in the secondary market was LTL 1.5 billion as compared to an outstanding stock of securities of LTL 2.7 billion, slightly down from the share of outstanding stock relative to 2001. While activity is still low, the growing presence of insurance companies, and the entry of pension funds in the future, have the potential to add depth and liquidity to the market and enable it to serve as a source for the pricing of securities.

B. Savings Securities

22. **Following discussions with the authorities, the mission welcomed the discontinuation of the government's savings securities program, as these securities do**

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[6] Bank of Lithuania figures.

not fulfill the original intent of the instruments. The savings securities do not help deepen the financial markets as they cannot be traded and are a buy-and- hold instrument held to maturity. They are debt backed by the government, and as such, would be considered the safest of domestic instruments in which to invest, yet have traditionally been offered at rates higher than those on other riskier investments. Furthermore, there is a lack of transparency in the setting of interest rates for these instruments. While originally set in line with deposit rates, the interest rates on these securities are not market determined and, until very recently, set at rates above comparable bank deposit rates, competing with banks for savings. Of significant concern to the budget is that these instruments can be encashed at any time. If interest rates rise, the risk of encashment increases as other instruments become more attractive and the encashment could impose a significant cost on the budget. This cost is exacerbated by the substantial increases in the volume of recent purchases.[7] Lastly, the combination of encashment risk, interest payments, and the government's payment (to banks) of the buyers' commission fees (only recently decreased from 1.5 to 0.7 percent of sales)[8] make these a rather costly means by which the government raises financing and furthers financial market development.

23. **The mission recommended that the government promote treasury bills as an alternative savings option for the public.** As new issues of savings securities are ended, outstanding savings securities would be held until maturity for encashment with no option for rollover, resulting in the gradual redemption of the residual stock over the next three years. In addition, the shift to Treasury bills should be relatively straightforward as participation in the savings securities is similar to that of the t-bill market with respect to the administrative procedures required by banks and to the minimum purchase requirements of LTL 100.

V. Money and Foreign Exchange Markets

A. Foreign Exchange Market

24. **The foreign exchange market is the most well-developed of the financial markets, supported by the strength and credibility of the currency board regime**

[7] In 2002, the stock of securities outstanding increased from approximately LTL 174 million to LTL 477 million. However, in the first five months of 2003, the outstanding stock increased to LTL 784 million, as of end-May. According to the BoL, there are approximately 17,000 holders of these securities, making the average holding almost LTL 44 thousand per person, a significant per capita purchase. (In 2002, average monthly wages were LTL 1,119 or US$ 307.)

[8] A primary difference (and a significant one) between the savings securities and Treasury bills is the commission charged by commercial banks to customers on t-bill transactions, a fee which is not born by the customer purchasing savings securities. Instead, the government pays the commercial banks for the transactions fees involved in conducting the sales of savings securities, making the effective yield on savings securities even higher.

operating in Lithuania. Turnover in the foreign exchange market was approximately LTL 226 billion in 2002, increasing almost 170 percent from levels in 2001, an extraordinary increase over the 41 percent increase in turnover between 2000 and 2001. The first five months of 2003 had turnover of LTL 93.6 billion. Margins have narrowed and are on the order of 10 basis points, levels comparable to more developed markets. The dominant trading currency is now the Euro, comprising 83 percent of all trades. Transactions in US dollars have declined reflecting both the repegging and its recent weakening against the Euro, and now represent only 16 percent of foreign exchange trading, compared with 87 percent in 2001. Banks noted that foreign exchange trades are predominantly customer driven and that banks usually do not take positions in the market for themselves.

25. **Non-cash trading dominates the market at 97 percent of all transactions,** although spot transactions are still 87 percent of all non-cash trades. The remaining 13 percent took the form of foreign exchange derivative instruments, which are slowly increasing in usage, following losses resulting from unhedged US dollar positions in recent periods. Major banks actively promote hedging for customers subject to currency exposure and hedging arrangements are a slow but growing component of transactions with corporates.

26. **Swaps account for 85 percent of foreign exchange derivatives instruments** (LTL 26 billion in 2002), while outright forwards account for the remainder of the market. Furthermore, the foreign exchange swap market is the most frequently used means by which banks manage their liquidity, trading foreign exchange swaps for litas liquidity (although it should be noted that much of banks' liquidity management is centralized in the parent company overseas).[9] Options were popular throughout 2001, but have seen little market activity during 2002, as parent companies of some banks constrained the use of options for risk reasons. However, there is some evidence that interest is picking up in options, and some banks are examining the introduction of interest rate swaps and nondeliverable forwards in the future.

27. **The interbank market for foreign exchange is dominated by the three major banks, comprising roughly 80 percent of the market.** These banks have established credit lines amongst each other for unsecuritized lending. The smaller commercial banks, in contrast, operate similar to any other corporate client of the large banks, and have reduced credit lines and sometimes required securitization. Turnover in 2002 was LTL 8 billion, with overnight activity comprising about 80 percent of turnover. Derivatives account for over half of all interbank trades and are almost entirely comprised of swap transactions.

[9] The abolition of fixed fees on currency trading has furthered the use of foreign exchange to manage liquidity as the fees had been prohibitive, especially since positions are reversed in a few days.

B. Interbank Market for Litas

28. **In contrast to the foreign exchange market, which serves as the banks' primary means of managing liquidity, banks' liquid positions in litas have contributed to a weak interbank market.** Turnover was LTL 14.7 billion in 2002 and was characterized by bid offer spreads on the order of 120 basis points. Overnight lending dominates the market, at LTL 8.7 billion or 77 percent of activity. Contracts with maturities of up to one week account for LTL 1.8 billion (15 percent), but there is little activity beyond a one month time horizon. No derivative instruments are offered in the money market.

29. **The money market exhibits volatility in interest rates** reflecting the fact that the market is thin with three banks dominating the activity. Fluctuations in government deposits impact on bank liquidity and exacerbate the volatility in interest rates in the interbank market. The authorities acknowledge the less liquid conditions in the money market, but recognize that banks predominantly use the foreign exchange market for managing their liquidity, as well as the litas market's eventual disappearance with the accession to the EU and the adoption of the euro. Nevertheless, it would be desirable if Treasury balances were kept more stable and closer coordination between the government and the BoL in regards to the government's financial flows would help to smooth these fluctuations.

VI. Insurance Sector and Insurance Supervision

30. **As of end-December 2002, there were 31 insurance companies operating in Lithuania—nine life insurance and 22 non-life insurance.** Three of the latter were only writing credit insurance. In 2002, insurance premiums amounted to LTL 773.8 million, growing about 62 percent in 2002, of which non-life insurance exhibited the stronger of the two. Insurance penetration remains small, as gross written premiums increased from one percent of GDP to 1.53 percent between 2001 and 2002 (of which life accounts for .28 percent and non-life for 1.25 percent of the total).

31. **The insurance market is still highly concentrated in the three largest companies.** In 2002, these companies comprised 62.4 percent of gross premiums in the non-life insurance market and almost 77 percent in the life insurance market. The share of foreign capital control in the insurance sector is 52 percent, of which Germany is the largest share at almost 18 percent, followed by Denmark and Poland.

32. **The assessment of compliance with the International Association of Insurance Supervisors (IAIS) core supervisory principles undertaken during the November 2001 FSAP indicated weaknesses in the regulatory and supervisory practices of the insurance supervisory agency (SISA).** Based on recommendations in the IAIS assessment, a new draft Law on Insurance is being formulated.[10]

[10] The draft Law has been undergoing several stages of significant revisions and, at the time of the mission, the draft was not finalized. A complete translation of the latest version of the

(continued)

33. **Most of the concerns put forth in the IAIS assessment have been addressed in the draft Law reviewed by the mission and it is close to achieving the desired level of compliance.** (Box 2) The supervisory powers of SISA[11] have been strengthened, including tighter fit and proper tests and licensing criteria, a required internal audit service, and the establishment and confirmation by the directors of the independent risk management strategy of the insurance company. Procedures for monitoring, inspections and sanctions have been strengthened and a sanctions manual is being considered for development.

Box 2. Implementation of Recommendations from the International Association of Insurance Supervisors (IAIS) Assessment

Organization of an Insurance Supervisor (CP 1)

The Draft Law on Insurance states that the State Insurance Supervisory Authority (SISA) shall be named the Insurance Supervisory Commission under the Government of Republic of Lithuania (hereinafter referred to SC). SC is a public institution accountable to the Government.

The Draft Law specifies the conditions for the appointment of officials, stating that the chairman of SC shall be elected for a five-year term of office and recalled before the end of the term of office by the Government on the proposal of the minister of finance. The deputy chairman and three other members shall be elected for a five-year term of office and can be recalled before the end of the term of office by the Prime Minister on the proposal of the chairman of SC.

According to the Draft Law, only qualified citizens of the Republic of Lithuania with impeccable reputation may become members of SC.

The ability of SC to establish its budget, which shall be in coordination with the Government, is provided in the Draft Law.

The Draft Law specifies that SC has the right to define regulations on all aspects of prudential supervision, including the ability of SC to outsource its supervisory functions.

Specific provisions for dealing with consumers' complaints are introduced in the Draft Law.

The salary system of SC members is regulated in accordance with the Law on Remuneration of State Politicians, Judges and State Officers. Under the Draft Law, the salary structure and employment of SC staff will remain under the Law on Civil Service.

The legal protection scheme for SC staff will not be changed under the Draft Law, but will remain within the Law on Civil Service.

Licensing and Changes in Control (CPs 2–3)

Fit and proper tests for owners, directors and senior management are established in the Law on Insurance, which are currently in force. Also, according to the Draft Law, SC is granted with the power to refuse to issue or revoke a license where owners, directors and senior management do not meet fit and proper requirements.

Grounds for refusing a license are expanded in cases of: 1) unsatisfactory results of control of sources of

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draft Law was not available to the mission, only the translation of the earlier (and unrevised) version was made available.

[11] To be renamed the Insurance Supervisory Commission (SC) under the new Law.

funds; 2) the organizational or group structure of the applicant hinders effective supervision; 3) principles of anti-money laundering regulation are not met; 4) owners, and/or directors, and/or senior management are not fit and proper for their role; and 5) outsourcing contracts are thought to reduce the efficiency of the new entrant. SC cannot refuse a license for reasons pertaining to the economic environment, e.g., market size.

The time limit to process a license is extended up to six months from the submission of the application and other relevant documents.

An insurance company shall inform SC of all its outsourcing contracts. In accordance with grounds established by the Draft Law, SC is entitled to require insurance company to revoke such contracts.

Regarding a "file and use" approach for new products, SC shall have no right to require prior approval for standard conditions of an insurance contract, premium rates and other documents used in normal insurance contractual relations. SC shall have the right to verify correspondence of the submitted documentation on the provisions regulating insurance contractual relations. Submission of this information should not be a prior condition for the insurer's activity.

Corporate Governance and Internal Controls (CPs 4-5)

According to the Draft Law, the board of directors is required to pay due attention to the policyholders' interests.

Insurance companies shall have an internal audit service, which shall report certain information to the management board of the insurance company and SC.

The board of directors shall establish and review the independent risk management strategy of the insurance company, and establish the order of conclusion of insurance contracts by paying particular attention to the disclosure of information to the insured, equal and kind treatment of the insured, and the protection of interests of the insured. The Draft Law also requires that investment policies be established by the board.

Insurance companies shall have an internal auditor whose functions and duties are defined in the Draft Law.

An insurance company shall have a chief actuary, whose duties are defined in the Draft Law. At this stage of the Draft, it is not yet clear whether the actuary will be internal or external. However, in all cases, the chief actuary will be approved by the SC and required of all insurance companies.

Prudential Rules (CPs 6–10)

Asset valuation standards are established in the Government Resolution on Financial Accountability. According to the Draft Law on Insurance, SC will adopt a special regulation redrafting the Government Resolution by defining asset valuation standards more precisely.

The use of custodians was selected as an alternative form for custody and safekeeping of assets.

The investment limit on real estate was reduced from 40 percent to 20 percent of technical provisions (Order No 192 on Investment of Insurance Technical Provision Funds, approved on 27 June 2002 by the Minister of Finance).

The management board of the insurance company shall establish the strategic goals of the insurance company, the means to achieve these goals, and the supervision of the means and the evaluation of results. SC also will be entitled to adopt regulations concerning issues of management strengthening and transparent, reliable, and cautious management of the insurance company.

According to the Draft Law on Insurance provisions, SC sets orders and conditions, as well as restrictions and foreign currency matching criteria for asset cover, on insurance company's technical provisions.

If, due to the specifics of an insurance company's activities and insufficient application of standard solvency requirements, there is a threat that interests of the insured, covered person, beneficiary or the aggrieved third person will not be satisfied, SC has the right to require the insurance company to establish a higher than minimal solvency margin reserve. This is set out by acts of law--16 percent of premiums and 4 percent of

technical provisions for life insurance, in compliance with EU directives. (This is not yet imposed.) Capital levels must always remain above the Guarantee Fund.

According to the provisions of Draft Law on Insurance, SC shall be empowered to pursue additional supervision of companies that belong to an insurance group.

SC has the right to oblige an insurance company to change or cancel concluded reinsurance contracts in the cases provided by the Draft Law.

Market Conduct (CP 11)

The management board of the insurance company shall establish the order of conclusion of insurance contracts, which shall also be applicable to companies of insurance agents, with particular attention to the disclosure of information. This implies equal and kind treatment of the insured, the protection of interests of the insured, and shall also establish the procedures for the examination of complaints submitted by the insured, covered persons, beneficiaries, and injured parties; this procedure shall be publicly announced.

Relations with policyholders are monitored according to the Order for Conducting Inspections in the Insurance Companies and Insurance Brokers, adopted by SISA and to be established in the recast Order adopted by SC.

The development of standards of market conduct will be the responsibility of the industry's self-regulatory body.

Monitoring, Inspection, and Sanctions (CPs 12–14)

Statistical information, as regards direct insurance activity, can be filed electronically by the insurance company.

The Draft Law on Insurance defines precise grounds for supervisory intervention and the development of a sanctioning manual is under consideration by SISA.

With a view to preventing the insolvency of insurance companies or a situation when the assets appropriated to a branch of a foreign insurance company fall below the branch's obligations and/or with a view to ensuring protection of the interests of the insured, covered person, beneficiary, and injured parties, SC shall have the right to oblige the insurance company or the branch of the foreign insurance company to transfer rights and duties stemming from insurance contracts to entities intending to take them over.

SC shall nominate to the court the candidates for the post of liquidator or of liquidation commission and its chairperson. Having passed a decision to liquidate an insurance company, to appoint a liquidator or liquidation commission and its chairperson, the court must notify SC in writing within three working days.

Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality (CPs 15–17)

SC shall refuse to issue authorization for the insurance activity of a branch where the competent authority of the foreign state does not implement efficient supervision of that insurance company and does not protect the interests of the insured, covered person, beneficiary, and injured parties.

34. **However, the draft Law considerably limits the financial independence of the insurance supervisory agency**. While the commissioner of SISA will be regulated in accordance with the Law on Remuneration of State Politicians, Judges and State Officers, the salary structure and employment of staff will remain determined by the Law on Civil Servants.[12] As a result, salaries do not appear to be sufficient to retain highly skilled staff,

[12] This is in line with the arrangements for the Securities and Exchange Commission, but differs from that of the Bank of Lithuania.

such as actuaries, an issue identified in the IAIS assessment conducted during the FSAP. There is a risk of high turnover as skilled staff leaves the supervisory agency for the more lucrative private sector, leaving SISA faced with the repeated retraining of new staff. This is particularly worrisome in light of the added responsibility of pension fund supervision that will be given to SISA. As in the FSAP, the mission recommended that SISA be allowed to establish an independent remuneration system.

35. **While tax revenues from the insurance industry go directly to SISA's budget, SISA can access only those funds approved by the budget.** The new supervisory agency will be financed by a fee of up to 0.5% of gross premium income and will be able to hire external advisors at will. However, it will not be able to charge individual companies for ad hoc activities that cannot be conducted in house by the new supervisory agency. This ability should be available to the agency.

36. **With the introduction of voluntary pension funds, SISA will also undertake supervision and regulation of pension funds within life insurance companies.**[13] Although pension funds are a new area for SISA, they are related to the unit-link products currently offered by insurance companies and regulated by SISA. At present, there are no pension funds, although there are some pension instruments offered by life insurance companies. However, they are not very active, with only about 1,000 written contracts.

37. **Legislation will be required regarding the regulatory structure of pension funds.** Areas of concern need to be clarified to provide a framework for pension funds, including figures establishing administrative costs of pension funds versus investment activity; fee structures will need to be clarified for accounting purposes; and rules and formulas for the valuation of assets. At present, SISA does not have the right to deny the acquisition of a pension fund by an insurance company. Legislation should be drafted on the licensing of pensions funds and the necessary requirements for establishment.

38. **At the time of the mission, there was no expectation of strong growth of pension funds in the next year or two.** Funds in the second pillar are estimated to be only LTL 20 million in 2004. Significant growth is not expected until 2005-06. Therefore, concerted efforts to strengthen the infrastructure of insurance and pension supervision need to be made in the interim period. Legislation must be in place establishing the general regulatory framework, including rules and licensing to be prepared for these pension funds coming on line. In addition, SISA would need assistance to strengthen its supervisory capacity to properly supervise these areas, and would require adequate numbers of highly-trained staff, and salaries to ensure retention of staff.

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[13] New pension funds (outside of insurance companies) will be regulated by the Securities and Exchange Commission.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/115
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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with the Republic of Lithuania

On September 5, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Lithuania.[1]

Background

The Lithuanian economy is enjoying a broad-based economic expansion with very low inflation, despite the slowdown in Europe. Real GDP grew by 6.7 percent in 2002 and by 9.4 percent in the first quarter of 2003. Investments and exports continued to be a major source of growth, while consumption has gradually accelerated. The current account deficit widened somewhat in 2002 to 5.3 percent of GDP, due to the fast growth of investment-related imports. Despite the real appreciation of the litas vis-à-vis the U.S. dollar, competitiveness remains strong, reflected in the good export performance with substantial gains in market shares. Fiscal consolidation continued: the general government budget recorded a deficit of 1.2 percent in 2002 and a surplus of 0.8 percent in the first quarter of 2003.The unemployment rate declined to a four-year low of 9.4 percent in June 2003.

Money and credit aggregates grew rapidly in 2002 and in the first quarter of 2003, with monetization converging toward the level of other advanced transition economies. Credit to the private sector expanded by 35 percent, albeit from a low base, in response to low interest rates and increased economic activity. This rapid private sector credit expansion does not give rise to

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

immediate concern, however, in view of the high-quality banking supervision, but will require continued monitoring.

The authorities' strategy to join the ERM II very soon after accession, maintaining an unilateral commitment to the Currency Board Arrangement, and adopt the euro after two years of successful membership of ERM II and continued compliance with the Maastricht criteria, subject to the agreement of the relevant European Union authorities, appears appropriate, provided that domestic policies, in particular fiscal policy, continue to be supportive and competitiveness remains appropriate.

Fiscal policy remains anchored to the objective of reaching a structurally balanced budget in the medium term. However, driven by the need to accommodate upfront expenditure related to EU membership, the fiscal deficit for 2003-04 is expected to deviate from the medium-term fiscal path. This widening of the fiscal deficit should not jeopardize macroeconomic stability provided that it remains limited and temporary, given the current strong economic position, the good track record of prudent economic policies, and the authorities' commitment to medium-term fiscal balance.

Progress in structural reforms was recorded during the past year, but deeper reforms are needed to underpin growth and employment creation. EU funds are expected to provide resources to help restructure the agricultural sector, and privatization appears to be picking up speed with a number of large sales expected in 2003. In addition, a meaningful pension reform is needed to ensure the long-term viability of the pension system, which would stimulate private savings and financial markets.

The potential for sustained economic growth is in place provided prudent macroeconomic policies and structural reforms to improve the business environment continue. The stable macroeconomic environment and restructuring undergone in the past three years have enabled businesses to achieve profit growth. EU accession should provide additional stimulus due to the inflows of grants and opportunities created by further integration of trade and finance.

Executive Board Assessment

Executive Directors commended the Lithuanian authorities for their successful implementation of sound economic policies that have led to a strong economic expansion with very low inflation and to Lithuania's graduation to a non-program relationship with the Fund. Directors welcomed Lithuania's signing of the EU Accession Treaty last April, and considered Lithuania well-placed to achieve a reasonably rapid integration into the euro zone. Nevertheless, Directors noted that unemployment and the external current account deficit remain relatively high—though unemployment has moderated somewhat recently—and encouraged the authorities to continue pursuing policies aimed at maintaining macroeconomic stability and furthering structural reforms necessary to raise productivity and sustain high growth.

Directors were of the view that the currency board arrangement continues to serve Lithuania well and has helped to anchor macroeconomic stability. They noted the real appreciation of the

currency and advised that Lithuania's competitiveness and external vulnerability be monitored closely. Directors endorsed the Lithuanian authorities' strategy of seeking early entry into ERM II after accession and maintaining the unilateral commitment to the currency board arrangement until the adoption of the euro. They noted that all relevant decisions regarding ERM II entry and EMU participation should be made in mutual agreement with the EU authorities. Furthermore, they underscored that the success of the ERM II strategy hinges on the ability of the authorities to maintain prudent policies, in particular rigorous fiscal discipline.

Directors commended the progress made in recent years in lowering the fiscal deficit, noting that Lithuania is one of the few accession countries that already comply with the fiscal convergence criteria of the Maastricht Treaty. However, they observed that in both the near and the medium term, the authorities face upward pressure on public spending and a projected further decline in the revenue-to-GDP ratio. In this regard, Directors urged the authorities to meet the budgeted fiscal deficit for 2003, limit the 2004 deficit to significantly below 3 percent of GDP, and develop a credible medium-term fiscal plan that takes into account all outstanding fiscal liabilities. They emphasized the need to leave adequate room for countercyclical policies in the event of a slowdown or adverse external shocks, and to prepare for the future fiscal costs associated with a rapidly ageing population. They stressed the importance of carefully prioritizing expenditure, resisting spending pressures in the run-up to parliamentary elections, and eliminating expenditure arrears. They noted that any slippages that would threaten compliance with the Maastricht criteria and commitment under the Stability and Growth Pact would undermine confidence in the currency board arrangement, macroeconomic stability, and the strategy for an early adoption of the euro.

Directors expressed concern about the decline in revenue and underscored the need to stabilize tax revenue in GDP terms by eliminating tax exemptions and improving tax administration. They noted that the tax reform had failed to stabilize revenue and urged the authorities to find alternative sources of revenue in the event the elimination of some taxes is required.

Directors stressed the need for strict banking and insurance supervision and high standards in bank credit management given the rapid growth in credit. They endorsed the authorities' plan for a gradual reduction of the reserve requirement ratio to the ECB required level, while underscoring the need to proceed with caution. Directors welcomed the efforts made by the Bank of Lithuania to implement FSAP recommendations and the favorable assessment of the FSAP follow-up report. Directors welcomed the steps taken by the Bank of Lithuania to increase its ability to detect and prevent money laundering and financial crimes, which include strengthening of bank inspection and reporting requirements and better cooperation between financial and law enforcement agencies.

Directors noted mixed progress in structural reforms, and urged the authorities to step up their reform efforts. While the financial situation of the Health Insurance Fund and municipalities has improved, more measures are required to enhance the efficiency of the health sector and solve the underlying problems of municipalities. Given the ageing population, Directors underscored the importance of adopting measures that would ensure the long-term viability of the pension

system. They welcomed the first steps taken to develop a privately- and voluntarily-funded pension system.

To sustain rapid investment and economic growth, Directors put special emphasis on energy and transport privatization, the modernization of the agriculture sector, and streamlining of the legal framework to enhance transparency, governance, and the overall business environment. They stressed the need for measures to increase labor market flexibility in order to generate jobs and reduce regional income disparities. In this context, they emphasized the importance of reforming the social safety net to improve efficiency and achieve better targeting. Directors also commended Lithuania's open trade policy, while noting that harmonization of the country's trade regime with that of the EU may result in an increase in some tariffs.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

The Republic of Lithuania: Selected Economic Indicators

	1999	2000	2001	2002
	Changes in percent			
Real Economy				
Real GDP	-1.8	4.0	6.5	6.7
Unemployment rate (end of period)	10.0	12.6	12.9	10.9
Consumer price index (end of period)	0.3	1.5	2.0	-1.0
	In percent of GDP			
Public Finance				
General government fiscal balance	-8.5	-2.8	-2.0	-1.2
Total government debt	29.0	29.5	28.3	27.0
External government debt	22.5	21.2	20.1	14.2
	Changes in percent			
Money and Credit				
Reserve money	-4.0	-3.3	8.3	20.8
Broad money	7.7	16.5	21.4	16.9
Credit to the private sector	13.8	-1.2	15.4	30.4
	In percent of GDP unless otherwise specified			
Balance of payments				
Trade balance	-10.3	-6.5	-5.5	-5.7
Current account balance	-11.2	-6.0	-4.8	-5.3
Gross official reserves (in millions of U.S. dollars)	1,244	1,344	1,657	2,400
Exchange rate				
Exchange rate (litas per US$, average period)	4.00	4.00	4.00	3.67
Exchange rate (litas per euro, average period)	4.26	3.69	3.58	3.42

Sources: Lithuania authorities and IMF staff estimates

Statement by Benny Andersen, Alternate Executive Director for Republic of Lithuania and Gierdrius Sidlauskas, Assistant to Executive Director
September 5, 2003

Our Lithuanian authorities would like to express their appreciation to Ms. Alonso-Gamo and her team for the high quality of their work. Our authorities broadly agree with the analysis and recommendations of the staff, including on the key economic challenges facing Lithuania.

With the last precautionary stand-by arrangement (SBA) completed earlier this year, this is the first stand-alone consultation with Lithuania. Our Lithuanian authorities appreciate this new level of cooperation, and they would like to use this opportunity to emphasize the very constructive dialogue and fruitful cooperation, which consistently have characterized their relations with the Fund. The framework of precautionary SBAs, together with regular Fund surveillance and well-targeted technical assistance, has been very useful in guiding policies through the significant challenges of reform and transformation. The authorities would also like to place on record their strong appreciation for Mr. Odling-Smee's effective and visible contribution to the Fund's successful involvement in Lithuania's reform and macroeconomic stabilization efforts over the years.

With the reform process well advanced and a well-established track record of stability-oriented policies, Lithuania is well placed to deal with the significant challenges looking ahead, including within an enlarged EU as from May 1, 2004. The strong support the Lithuanian citizens expressed this May in the Accession referendum to join the EU encourages the authorities to move ahead on a fast track seeking membership of the ERM II soon after accession and subsequently to adopt the Euro upon a successful convergence assessment after the minimum required period of two years of participation in ERM II. They consider January 1, 2007 as a realistic date for Lithuania to adopt the euro.

Recent Economic Developments

Despite a prolonged period of subdued economic activity in many of Lithuania's European trading partners, growth in the Lithuanian economy has remained brisk leading to a significant catching up toward the euro area average. Led by booming investment and export, and supported by gradually increasing consumption, growth is outperforming the expectations for the third year in a row, reaching 6.7 percent in 2002 – the highest among EU acceding countries. Real GDP grew by 7.7 per cent in the first half of 2003. A higher gross value added was generated in all economic activities, in particular in manufacturing, electricity, gas and water supply, construction, wholesale and retail trade. The Ministry of Finance is projecting economic growth of 6.8 percent for the year as a whole.

Although domestic demand has been strong, inflation has been low since 1999 and prices are expected to remain stable. During the last year, the Lithuanian economy has been experiencing negative annualized rates of inflation. However, the impact of falling prices on the real economy is not deemed to be significant as witnessed by the vibrant private sector

activity, and the falling prices can mainly be attributed to one-off price developments related to a drop in agricultural prices following a very good harvest in 2002 and the impact of nominal real exchange rate appreciation. The authorities consider trend inflation to be around 2-3 percent but due to falling prices of food and clothes they are expecting a negative inflation of 0.9 in 2003. They expect inflation to pick-up to 1.9 percent in 2004 due inter alia to the abolition of certain VAT exempts. The inflation is expected to reach 2.1 and 2.2 percent in 2005 and 2006 respectively.

While the current account deficit increased slightly to 5.3 percent of GDP in 2002, a number of factors support the view that the economy remains highly competitive. Measures of real effective exchange rates based on unit labor costs show no discernible appreciation over recent years and exports continue to be strong with further advances in market shares. Foreign direct investments have approximately covered the entire current account deficit both in 2002 and in the first months of 2003. Since 2000, FDI inflows have been increasing substantially while privatization receipts have seen a steady decline. Accordingly, the FDI seems to be linked primarily to the expansion of existing operations in Lithuania, supported by the profitability of earlier investments.

The sustained pursuit of sound policies and the resulting favorable outlook for growth and inflation are increasingly being rewarded by markets with a significant narrowing of interest rate spreads to the euro area. Short-term interest rates spreads have remained around 50 basis points in recent months. It is also worth mentioning that a major credit agency has upgraded the credit ratings already twice this year. In early March, Lithuania successfully issued a 10-year €400 million Eurobond (bids totaled €800 million) at a record-low coupon rate of 4.5 percent. The euro-denominated Eurobond was issued under English law and therefore contained Collective Action Clause provisions.

Fiscal Policy

A sustained strict fiscal policy has led to a considerable decline in the budget deficit in recent years, from 8.5 percent of GDP in 1999 to 1.2 percent of GDP in 2002 according to the IMF staff calculations. Meeting the fiscal target of 2.1 percent of GDP for 2003 (1.8 percent adjusted for an EFF early repurchase made in January) remains within reach, as the implementation of the budget for 2003 remains on track. For 2004, the authorities expect the deficit to temporarily widen to 2.9 percent of GDP, subsiding thereafter to 2.5 percent of GDP in 2005 and 1.8 percent of GDP in 2006. The public debt to GDP ratio is expected to stay at around 25 percent.

The temporary and limited loosening of the fiscal stance for 2004 can to a large extent be attributed to one-off expenditures related to EU accession and NATO membership. The authorities are cognizant that the expected deficit would leave very little if any room for counter-cyclical policies should they become warranted, but would like to underscore their strong commitment to the requirements of the EU framework, including to contain the fiscal deficit within the limit of 3 percent of GDP, and also to achieving a structural balanced budget over the medium term.

Our authorities concur with staff that the decline in the tax revenue-to-GDP ratio warrants attention. Further revenue losses will likely materialize in 2004, when the important changes have to be made. The authorities agree that alterative resources of revenue to offset these losses are needed, also in view of the likely intensified expenditure pressures in connection with the 2004 general elections. Accordingly, they will continue their efforts aimed at improving tax administration and fight tax evasion and implement the Fiscal ROSC recommendations with strong attention to the need for promoting transparency.

The government continues to work with municipalities to balance the local finances, and this year an amendment to the Law on the Methodology of Determination of Municipal Budgetary Revenues will be submitted to the Parliament. The Ministry of Finance has also established a working group to prepare the draft Local Tax Concept with the aim to expand the possibilities for municipalities to increase their financial resources.

Monetary Policy and Exchange Rate Policy

Lithuania's experience with their currency board arrangement continues to be favorable. The Lithuanian litas was pegged to the USD from 1994 until February 2002, when it was repegged to the euro, while maintaining all other features of the CBA unchanged. The re-pegging to the euro went smoothly, supported by a clear and transparent communications policy.

The Bank of Lithuania and the Lithuanian Government aim to join the ERM II soon after accession to the EU, acknowledging that all relevant decisions are taken by mutual agreement within the adopted framework. Our authorities plan to retain the existing CBA as an unilateral commitment complementing ERM II participation. The authorities continue to believe that this framework is the most conducive for achieving real and nominal convergence with the EU. The Bank of Lithuania is also gradually aligning the monetary policy instruments with the ones of ECB to be ready to adopt the Euro-system's monetary policy instruments.

Our authorities realize the importance of an economic policy tuned to meet the Maastricht criteria in a sustainable manner, both before and after ERM II membership. They envisage participation in the ERM II for the required minimum two year period and are aiming at keep fulfilling the Maastricht criteria and adopt the euro after a successful convergence assessment.

Banking Sector

The follow-up assessment of financial sector issues examined during the 2001 FSAP found that the banking sector system has exhibited a steady strengthening, with the efforts of the supervisory authorities contributing to increased soundness of banking prudential indicators, well-capitalized banks, improved bank profitability, and falling non-performing loans. The supervisors have made progress with the implementation of the FSAP recommendations as well as the recommendations of the EU peer review mission. Moreover, advanced techniques

for supervision of operational risk, e-banking and mortgage loans are being implemented. Consultations with commercial banks on the preparations to apply the drafted New Basle Capital Accord are also taking place.

The increased quality and competitiveness of banking services, lower interest rates, and the robust economic growth have led to a rapid credit expansion. The authorities agree with the staff that the strong credit expansion does not pose immediate risk and remains manageable. Credit has expanded rapidly from a low base and is to a significant degree being channeled towards fixed capital formation. At the same time, they are fully aware that developments need to be closely monitored, and as a precautionary measure the Bank of Lithuania has decided not to rush lowering the reserve requirement from 6 percent currently towards the 2 percent prescribed by the ESCB.

Structural Policies

Unemployment continues to decline steadily. This July it fell to 9.5 percent of the labor force compared with 10.7 percent in July 2002. However, labor skills mismatches keep structural unemployment from falling sharply. The government is implementing a special four-year program to address this issue. The Ministry of Social Security and Labor recently implemented a special program to harmonize social and employment policy with the EU requirements.

The second pillar of pension systems - private pension funds – will become operational from the start of 2004. The employees will be free to choose to participate or not in this pillar by directing 2.5 percent of their salary to a designated private pension fund and the share of the salary will be increased gradually to 5.5 percent by 2007. The step-by-step strategy was chosen to ease the pressures on the budget of the mandatory Social Insurance Fund due to redirected contributions to the private funds. It is worth noting that the tax incentives promoted a surge in life insurance therefore increasing private contributions to a social safety net.

The authorities continue to proceed with the privatization of the remaining public enterprises even though 74 percent of GDP is already being created by the private sector. More than 500 entities were privatized from the beginning of the year, although most of them were very small. Given the importance of the energy sector, a careful approach was taken in privatizing the remaining public stake in the key energy sector enterprises. Nevertheless, negotiations and privatization process are moving ahead steadily. Privatization and restructuring of the remaining public enterprises should strengthen productivity growth.

The authorities are prepared to make an effective use of EU structural funds to address regional development discrepancies as well as to promote efficiency in the agricultural sector. It is worth mentioning that the society is very conscious about the importance of transparency and efficiency in the use of EU funding and the authorities are acting promptly to remove any weaknesses in EU funds administration. It is estimated that in case of

successful utilization of the EU structural funds, the GDP growth could be promoted by up to one additional percentage point a year.