INTERNATIONAL MONETARY FUND

IMF Country Report No.11/326

REPUBLIC OF LITHUANIA

2011 ARTICLE IV CONSULTATION

November 2011

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 2011 Article IV consultation with the Republic of Lithuania, the following documents have been released and are included in this package:

- **Staff Report** for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 10, 2011, 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 November 1, 2011. 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.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its November 16, 2011 discussion of the staff report that concluded the ArticleIV consultation.
- **Statement by the Executive Director** for the Republic of Lithuania.

The document listed below has been or will be separately released:

- **Selected Issues Paper**

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 2011 ARTICLE IV CONSULTATION

November 1, 2011

KEY ISSUES

Near term outlook and risks. The economy has staged an impressive recovery, with real GDP expected to grow by 6¼ percent in 2011. The export-led recovery has broadened to domestic demand, and the unemployment rate has fallen. Looking ahead, weaker external demand and higher external financing costs will slow the economy, with growth in 2012 projected at 3½ percent. Risks are clearly on the downside. An intensification of global financial strains could lead to even weaker external demand and jeopardize funding. With external conditions worsening, the priority is to reinforce macro stability.

Fiscal policy. The fiscal deficit has narrowed substantially since 2009, mostly reflecting expenditure restraint. A further reduction in the fiscal deficit to 2.8 percent of GDP in 2012 is essential to put debt on a downward path, reduce financing needs, and preserve euro adoption aspirations. Attention should be paid to the sustainability of the adjustment, including by ensuring that any further spending cuts protect the most vulnerable. Beyond 2012, additional consolidation will be needed to reach the medium-term objective of a small budget surplus.

Financial stability. While the banking system as a whole appears well-positioned to withstand adverse shocks, prompt corrective action is needed to address remaining pockets of weakness. The strong recovery has boosted banking system profitability; substantial increases in capital have raised the average capital adequacy ratio; and the average liquidity ratio is well above the regulatory minimum. However, some banks have made lower loan loss provisions than other banks, despite having higher NPL ratios. In these banks, it will be necessary to assess risks conservatively, to make adequate loan loss provisions, and to increase capital if needed.

Sustainable growth. The economy has started a welcome rebalancing towards tradable sectors. Sustained growth over the medium term will require increased labor participation, labor reallocation to tradable sectors, and higher investment. To support the latter, further efforts are needed to improve the business environment.

Political situation. The government has a one-vote majority in parliament. Parliamentary elections are expected in October 2012.

Approved By
Anne-Marie Gulde and Claire Waysand

Mr. Morsink (Head), Mr. Miniane, Ms. Menkulasi (all EUR), Mr. Olafsson (MCM), and Mr. Poghosyan (FAD) visited Vilnius from September 29 to October 10, 2011 and met with Prime Minister Kubilius, Finance Minister Simonyte, Central Bank Governor Vasiliauskas, other senior officials, members of Parliament, and private sector and civil society representatives. Mr. Bartkus (OED) participated in the discussions. Lithuania is an Article VIII country (Information Annex, Appendix I). Data provision is adequate for surveillance (Information Annex, Appendix II).

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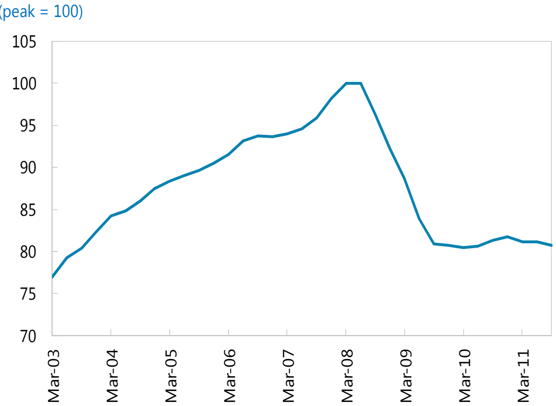
CONTEXT

A. Recent Developments

1. **Following a sharp output decline in 2008 and 2009, Lithuania has staged one of the strongest recoveries in Europe.** The economy contracted by a cumulative 18 percent between the second quarter of 2008 and the last quarter of 2009, the fourth largest peak to trough contraction in the world after Latvia, Ukraine, and Estonia. But the revival in exports that started in mid-2009 lifted the economy out of its slump, with GDP expanding by 1.4 percent in 2010 and by 6.3 percent in the first half of 2011.

2. **Export growth has been the main driver of the recovery.** Exports were underpinned by strong economic growth in Lithuania's main trading partners, including Germany, Poland, and Russia. Sharp nominal wage declines helped restore competitiveness, leaving Lithuania well positioned to take full advantage of higher external demand. Staff estimates that the real exchange rate is now broadly in line with fundamentals (Box 1). Finally, prices for some of Lithuania's key agricultural exports have soared.

REER, Manufacturing ULC-based
(peak = 100)



Sources: EU Commission; and IMF staff calculations.

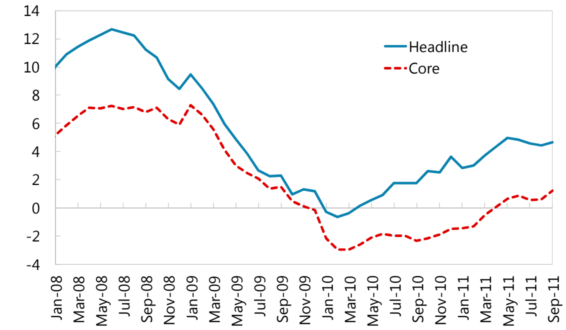
3. **Booming exports raised corporate profitability and improved the labor market.** Higher sales revenue boosted corporate profitability, with the aggregate operating surplus and mixed income up by some 60 percent since early 2010, and almost back to pre-crisis levels. The unemployment rate, which rose sharply from mid-2008 until mid-2010, has started to fall. The ratio of vacancies to unemployed has risen. As a result, private sector average gross earnings, which had fallen by some 12 percent from late 2008 (substantially more in some sectors like construction), have picked up again, rising by a cumulative 2.5 percent in the last three quarters, more than offset by strong labor productivity growth.

4. **As a result, the recovery has broadened to domestic demand.** Improvements in the labor market and rising consumer confidence have fed into private consumption. Car sales have been especially strong, reflecting pent-up demand. On the corporate side, improved profitability and rising capacity utilization rates led to higher fixed investment. Gross fixed capital formation, which contracted sharply until mid-2010, has risen vigorously. The rebuilding of inventories also contributed strongly to growth in 2010.

5. **Rebounding domestic demand, import-intensive exports, and higher energy prices have boosted imports.** With oil-related products constituting a third of total imports, the rise in global energy prices that lasted until mid-2011 was an important factor. But non-oil imports have also been

strong, including consumer durables and capital goods. As a result, the current account swung from a 1.5 percent of GDP surplus in 2010 to a 1 percent of full-year GDP deficit in the first half of 2011.

6. The surge in food and energy prices raised headline inflation, but pressures are now abating. With food and energy accounting for 40 percent of the CPI basket, higher heating costs stemming from the closure of the Ignalina nuclear plant in January 2010 and the run-up in food prices quickly translated into higher headline inflation, which peaked at 5.0 percent in May 2011. Since then, food and energy prices have been falling on a m/m basis, in line with global trends, bringing headline inflation down to 4.7 percent in September. After more than a year of deflation, core prices started rising y/y in April 2011. Core inflation was 1.2 percent in September, led by items such as clothing and hotels, cafes, and restaurants.



Sources: Haver; and IMF staff calculations.

B. Near-Term Outlook and Risks

7. Growth is expected to slow sharply. Given slowing external demand and uncertainty about prospects, q/q growth (s.a.) is projected to be only about 0.5 percent (annualized) in the second half of 2011. For the year as a whole, this implies growth of 6.3 percent, given the very strong first half. In 2012, the economy is expected to gradually regain momentum, in line with the baseline view in the Fall 2011 WEO that tensions in the global economy will be resolved. Annual growth in 2012 is projected to be 3½ percent. As a result, the estimated negative output gap should narrow from 2.7 percent in 2011 to 1.4 percent in 2012 (compared to 6.1 percent in 2010).

8. The external current account deficit should remain manageable. The current account deficit is expected to widen a little in 2012, as the slowdown in domestic demand is projected to be less sharp than that of exports. In both 2011 and 2012, the modest current account deficits will be more than financed by EU capital transfers. In the financial account, net FDI is expected to be strong, and repayments of liabilities by domestic bank subsidiaries to their Scandinavian parents are expected to decline, in line with recent trends.

9. The labor market should continue to improve. The unemployment rate is projected to fall from 15.5 percent in 2011 (yearly average) to 14 percent in 2012. Staff expects average nominal gross earnings to grow by 3.3 percent this year and 4.1 percent next year.

10. Headline inflation is expected to moderate going forward. Consumer price inflation is projected to fall to 3.8 percent at end-2011, reflecting the easing of food and energy price inflation, in line with recent declines in international commodity prices. Core inflation is expected to rise only modestly, given still-high unemployment and a negative output gap. The projected continuation of these trends (low non-core inflation, core inflation rising slowly up to 2 percent) would result in 2.7 percent inflation at end-2012 (and an annual average rate of 3.1 percent). While the uncertainties surrounding inflation forecasts are large, it appears at this stage that Lithuania may not meet the Maastricht inflation criterion in 2012, given the inflation forecasts for other EU countries.

11. Risks to growth are clearly on the downside. Turmoil in the global economy presents two major risks for Lithuania:

- *Heightened uncertainty.* Both in Lithuania and elsewhere, heightened uncertainty could push consumers and firms to defer investment spending, firms to defer hiring, and banks to defer extending credit. Lithuania is particularly exposed as 30 percent of its exports go to the euro area.

- *Global financial markets freeze*. While external debt has fallen since 2009 as foreign-owned banks have reduced liabilities to their parents, it remains relatively high. The government has fully financed current year needs, but increases in external borrowing costs would weigh on the country given some 8 percent of GDP in gross financing needs for next year. In the banking system, subsidiaries or branches of Scandinavian banks account for three quarters of total assets. The parent banks rely on wholesale markets to cover about half of their total funding. However, the Scandinavian authorities are well prepared to deal with liquidity pressures on their banks, given their sizeable reserves, their preparedness to extend the range of acceptable collateral, and the possibility of re-activating swap lines with major central banks.

Authorities' views

12. The authorities broadly agreed with staff's assessment of the outlook and risks. They shared the view that growth and inflation are likely to slow going forward, and that risks are firmly on the downside. They underlined Lithuania's small size and high degree of integration into the European economy. At the same time, they considered that the impact of any global crisis would be smaller than in 2008–09, as large imbalances have been corrected. The authorities concurred with staff that there is no remaining competitiveness gap in the real exchange rate.

POLICY CHALLENGES

A. Reducing Government Debt and Financing Needs

13. The fiscal deficit has narrowed substantially since 2009, reflecting mainly expenditure restraint. The general government deficit (ESA basis) declined from 9.2 percent of GDP in 2009 to 7.1 percent of GDP in 2010. In the first half of 2011, it fell by 1 percentage point of GDP compared to the first half of 2010 (Figure 2). Staff projects a fiscal deficit of 5.1 percent of GDP for 2011 as a whole, compared to the government's original target of 5.8 percent of GDP (set in the 2011 budget) and the revised target of 5.3 percent of GDP (set in the Convergence Program). In particular:

- *Expenditure*. Wage cuts instituted in 2009 resulted in a substantial decline in the wage bill from 2009 to 2010, and these gains are being preserved in 2011. Similarly, social benefit payments—notably pensions and parental benefits—were reduced. All in all, staff expects total expenditure to fall by 3 percentage points of GDP in 2011, despite higher debt service costs.

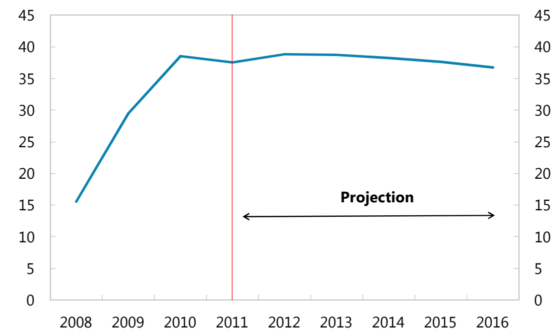
- *Revenue*. VAT and excise duties are growing fast, consistent with staff analysis that suggests that VAT yields are pro-cyclical (Box 2). However, direct taxes and social contributions lagged behind, as wages and employment have grown less quickly than nominal GDP.

14. Looking ahead, the government's 2012 deficit target of 2.8 percent of GDP and medium-term objective of a small surplus are appropriate. In addition to preserving euro adoption aspirations, a further reduction in the fiscal deficit is needed to reduce financing needs, put debt firmly on a downward path, and prepare for population aging:

- *Financing needs*. The government has fully financed 2011 needs. However, the government has some 8 percent of GDP in gross financing needs next year, including refinancing the euro bonds that were issued in 2002 and 2006. As buffers, the government has several months of cash reserves. There may also be scope for greater domestic financing, given significant liquidity in the banking system and limited private demand for credit.

- *Regaining fiscal space*. Given its high exposure to external shocks and currency board arrangement, Lithuania needs room for automatic stabilizers to operate in downturns. With government debt now approaching 40 percent of GDP (up from 15.5 percent of GDP in 2008), such room is limited. A small medium-term surplus would put debt firmly on a declining path, regaining some of the fiscal space lost in the recent crisis.

General Government Debt
(Percent of GDP)



Sources: Statistics Lithuania; and IMF staff projections.

- *Population aging*. Lithuania's population is projected to fall by 20 percent between 2010 and 2060, with the dependency ratio rising from 1-to-4 to 1-to-2. The most recent EC *Sustainability Report* projects that, as a result of aging, government spending could rise by as much as 6 percent of GDP over the long term. In addition, rising health care costs could add a further 4 percent of GDP to spending.

15. While staff and the authorities agreed that measures worth 1–1¼ percent of GDP are needed to reach the 2012 target, staff emphasized that consolidation be sustainable (Table 5). One option would be to expand wealth taxation, given that such taxes are less distortive than other taxes, are progressive, and are relatively low in Lithuania. Specifically, the taxation of property and motor vehicles could be expanded to include non-commercial usage, with appropriate thresholds to protect poorer owners. Another option would be to broaden tax bases. For example, the base of social contributions could be broadened to include all earnings categories, CIT exemptions (such as the investment incentive) could be eliminated, and pensions could be taxed as regular personal income. In addition, staff recommended that any further spending cuts should aim to protect the most vulnerable, as well as preserve investment levels.

16. If downside risks to revenue materialize, further fiscal measures would be needed. While additional fiscal adjustment would be procyclical, the scope for a wider fiscal deficit is limited, as it would be more difficult to finance, could shake investor confidence, and would undermine euro adoption aspirations. Therefore, the government should draw up a list of saving measures that could be implemented quickly if revenue growth is weaker than expected.

17. Over the medium term, additional adjustment will be needed to achieve the government's medium-term objective. Based on announced policies and staff's medium-term outlook, cumulative adjustment of about 2 percentage points of GDP is required in addition to the 2012 effort. In this context, structural reforms are important:

- *Pension reform*. In June, Parliament approved a gradual increase in the pension age to 65 for both men and women, from 62.5 and 60 in the current system, respectively. This is an important step that is expected to deliver at least 1 percent of GDP in annual savings over the long run, but is insufficient in itself. Because of the size of demographic changes, and because benefits are indexed to wages, the system will not be sustainable without further reform. Staff thus supports recent guidelines on pension reform approved by Parliament which call for linking future benefits to demographic factors. In tandem with these reforms, the basic social pension could be separated out and financed from the general budget.

- *Health care reform*. The government is consolidating hospitals, given the relatively high number of hospital beds per capita, and concentrating medical procedures in fewer, higher-volume centers, so as to benefit from economies of scale.

- *State-owned enterprises (SOEs)*. With SOE assets accounting for some 25 percent of GDP, efficiency gains could yield substantial transfers to the government as well as benefit the economy as a whole. With this in mind, the government completed a major inventory of SOE assets last year, which has been published. There is also ongoing work to assess the social functions of SOEs. Rigorous cost-benefit analysis should be expanded, as some operations may be too costly given the social benefit they provide. Governance reform is also needed, particularly with respect to the independence and professional experience of boards of directors.

- *Tax compliance*. The government has launched an ambitious compliance strategy, supported by Fund technical assistance. A Commission for Coordination of Cooperation among State Economic and Financial Control Authorities has been set up to provide strategic guidance and monitor the implementation process. Following Fund advice, the State Tax Inspectorate (STI) has improved the allocation of resources earmarked for tax inspection, now focusing the majority of its efforts on a relatively small number of large and medium-size businesses representing about half of total turnover in the country. In addition, STI has put in place new training programs for tax inspectors, and legislative changes have been introduced allowing the government to collect unpaid taxes from enterprises facing bankruptcy proceedings. Going forward, staff supports the authorities' plans to tighten tax compliance further by expanding the use of cash registers, reducing loopholes through which business licenses can be used for tax avoidance, and stepping up the fight against border smuggling.

18. Improvements to the fiscal framework would help underpin medium-term consolidation efforts. Currently under consideration are amendments to the fiscal framework which would tighten rules on the use of Treasury reserves, strengthen the role of independent evaluation in budget planning and execution, and introduce an additional fiscal rule requiring a decline in the headline deficit of at least 0.6 percent of GDP whenever the projected output gap is positive. Tighter access to fiscal reserves would be an important step, as it would help discipline spending. At the same time, independent evaluation should be entrusted to a new body such as a fiscal council. Also, while the proposed additional rule provides a welcome focus on counter-cyclicality, it would be difficult to implement: linking it to the sign of the projected output gap is hard to manage effectively, and the setting of a 0.6 percent of GDP fiscal adjustment whenever the output gap is positive would seem arbitrary. Instead, it would be better to complement the existing expenditure rule, which provides sensible targets for the forecast horizon, with a "debt brake," in line with the objective of bringing debt down to well below 40 percent of GDP.

Authorities' views

19. The authorities underlined their commitment to the 2012 fiscal deficit target of 2.8 percent of GDP. However, they pointed to the difficulty of introducing new taxes in an election year. Instead, they said they would meet the target by increasing non-tax revenue and reducing spending. Given the strong financial performance of SOEs in 2011, they saw scope for higher dividend receipts of about ½ percent point of GDP in 2012. In addition, land sales could yield ¼ percent of GDP, and a change in the valuation method for the land tax (administered by local governments) could yield ¼ percent of GDP. They also planned to reduce ministries' spending allocations by 2 percent across the board, which would save another ¼ percent of GDP. Should downside risks to revenues materialize, they would consider a supplementary budget to achieve the 2012 fiscal target. Finally, they said that work on the fiscal rule is still ongoing and that they would take into account staff's suggestions.

B. Ensuring Banking System Resilience

20. The strong recovery has boosted banking system performance (Figure 3). Nonperforming loans, which rose sharply from mid-2008 to end-2009, have stabilized. Several banks, which provisioned aggressively for NPLs when they were rising, have recently reduced loan loss provisions. Lower loan loss provisions and higher net interest margins have supported an improvement in banking system profitability. Cumulative profits in the four quarters to 2011Q2 reached €188 million, compared with €1 billion in losses in previous four quarters. Return on assets improved from negative 4.8 percent at end-2009 to positive 1.3 percent in the most recent four quarters, close to ROA during the boom.

21. **The banking system as a whole is liquid and well capitalized.** Increases in capital, which in 2009-10 amounted to 3 percent of GDP or 40 percent of bank capital measured at end 2008, played a key role in preserving financial stability. Banking system prudential ratios are now well above regulatory minima: the average capital adequacy ratio was at 14.8 percent in 2011Q2, while the Tier 1 and core Tier 1 ratios were 11.4 percent and 10.3 percent respectively, above future Basel III requirements. Similarly, the average ratio of liquid assets to current liabilities was slightly above 40 percent (compared to the regulatory minimum of 30 percent); the central bank's preliminary calculations suggest that the liquidity coverage ratio was close to 200 percent, and the net stable funding ratio was slightly below 100 percent (the Basel III requirements for the latter two are minima of 100 percent).

22. **The banking system's strong capital position suggests that supply factors are not the main reason behind low credit growth.** Both stock and flow indicators of credit remain weak, but in staff's view this mostly reflects lack of demand as corporations and households continue to repair their balance sheets. Recently, greater uncertainty about global economic developments has dampened appetite for investment. On the supply side, it is reassuring that banks have tightened lending standards on construction and real estate related sectors (where excess capacity is large) but not on export sectors (which are growing rapidly). Anecdotal evidence suggests that there is competition among banks to provide credit to good corporate borrowers.

23. **Most banks are well-positioned to withstand further shocks.** While no Lithuanian bank was included in the EBA stress tests, recent stress tests by the Bank of Lithuania (BOL) show that, under a large decline (13 percentage points) in export volumes and a sharp spike (260–440 basis points) in interest rates, aggregate and median CARs would still remain above 10 percent. Similarly, the aggregate liquidity ratio would remain above 30 percent even with a 10 percent deposit drain, and would fall only marginally below 30 percent with a 15 percent deposit drain. While foreign-owned banks are dependent on funding from their parents (their average loan-to-deposit ratio is still about 150 percent), parents did not curtail funding abruptly in 2009–10.

24. **Despite generally encouraging developments, remaining pockets of weakness should be addressed without delay.** A few banks, which account for 15-20 percent of deposits and do not have liquidity backstops from foreign parents, have set aside lower provisions for losses than others despite having higher NPL ratios. Under the adverse scenarios in the BOL stress tests, these banks did not meet minimum capital requirements. Prompt corrective action is needed to address these weaknesses before they get bigger and to minimize any potential costs. Supervisors should enforce conservative assessment of risks in these banks, require adequate loan loss provisions,

and demand capital increases when this is warranted. If the need arises, the law provides the necessary authority to take adequate measures. In line with European and global initiatives, as well as earlier Fund technical assistance, it is urgent to broaden the range of resolution tools, for example to include a purchase and assumption option.

25. Plans to unify financial supervision should lead to better identification of risks and trouble spots. At present, the central bank is responsible for bank supervision, while insurance and securities companies are supervised by an insurance commission and a securities commission, respectively. A draft law currently in parliament would unify supervision (as well as a newly created consumer protection agency) under the BOL. Unification of supervision makes sense in Lithuania given economies of scope, with many insurance and securities companies owned by banks. Preparations to implement the new organizational structure in early 2012 are well under way. However, the draft law is silent about the reporting responsibilities of the head of supervision. It will be important that this function report directly to the highest governing body of the BOL. In addition, the imminent introduction of responsible lending guidelines (which include limits on loan-to-value and debt service-to-income ratios) should help contain systemic risk in the future.

26. More effective insolvency regimes are needed. A corporate insolvency regime exists, but is widely regarded as too slow, in part because the law does not provide adequate guidance to judges. A new law on a personal insolvency regime is currently in parliament. The proposed law is broadly in line with Fund advice. However, there is room for improvement in a few areas, notably to allow creditors (and not only debtors) to initiate bankruptcy proceedings. The draft law also lacks collective enforcement mechanisms when no plan has been submitted to or approved by the courts, or when proceedings have been declared terminated. It will also be important to ensure the availability of advisory services to debtors on their rights under the new regime.

Authorities' views

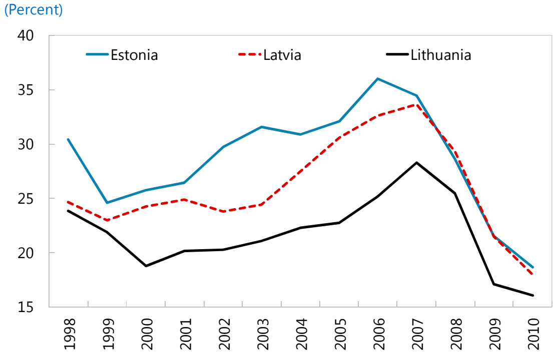
27. The authorities broadly agreed with staff's assessment of financial sector stability and risks. They said that they are determined to be proactive in assessing credit quality and requiring remedial action where necessary. They do not plan to allow creditors to initiate personal bankruptcy proceedings, as they consider that civil courts provide enough recourse.

C. Sustaining Growth over the Medium Term

28. Sustaining the recovery over the medium term will require balanced growth. During the economic expansion that preceded the crisis, resources were increasingly allocated to nontradable sectors, which have little room for productivity enhancements. Looking forward, it will be important that resources go to tradable sectors, which will also help minimize external imbalances. Early signs are encouraging (Box 3). The contribution of tradable sectors to Lithuania's strong recovery has been about 50 percent, much higher than during the pre-crisis boom. In addition, the sharp depreciation of Lithuania's ULC-based REER suggests that international price competitiveness is not a problem. However, there is not yet evidence of stronger employment growth in tradables compared to nontradables.

29. Sustained growth also requires strong investment (Box 4). The investment to GDP ratio fell sharply during the crisis. Under staff's central medium-term scenario, lower investment will lead to lower labor productivity growth, at precisely the time when the labor force is projected to shrink due to population aging and migration. Altogether, staff estimates potential growth of 3½–4 percent, which implies slower convergence of living standards to the EU average than before.

Baltic Countries: Fixed Investment to GDP Ratio
(Percent)



Sources: Haver; and IMF staff calculations.

30. Boosting employment participation and reallocating labor towards tradable sectors will be key. Sustaining even 4 percent potential output growth in the face of lower investment and a shrinking labor force will require large increases in the employment ratio, from around 60 percent currently to some 65 percent in the medium-term in the staff baseline forecasts. For this to happen, the labor market will have to reallocate resources towards growing sectors in the face of skill mismatches. To facilitate this process, staff support plans to make permanent changes to the Labor Code that allow greater use of fixed term contracts for new vacancies. Given that fixed term contracts are imperfect substitutes for permanent ones, temporary crisis measures which reduced firing costs on the latter could also be extended. In parallel, full use should be made of EU funds to support job schemes, expand training programs, and enhance the efficiency of labor bureaus. Finally, proposals to raise the minimum wage should be evaluated carefully, as they might slow job creation, reverse recent competitiveness gains, and increase government spending at this difficult time (as wages and benefits are tied to the minimum wage).

31. Efforts to improve the business environment are also important. Requirements for starting a business (including registration processes) have been commendably streamlined, though it will be important to ensure that the shorter timetable for obtaining a construction permit is implemented. The new law on business inspections is also welcome, as it separates policy making from policy implementation, increases transparency, and strengthens coordination among inspection agencies. Staff also supports the proposed law on strengthening the role of the Competition Council, as it would grant the council authority to more proactively investigate breaches of competition rules.

Authorities' views

32. The authorities shared the view that potential output growth has fallen since the crisis, with their estimate close to 4 percent. They agreed that sustaining growth will require reallocating resources towards tradable sectors despite skill mismatches. They pointed to initiatives to make the labor code more flexible, improve the business environment, and enhance efficiency in SOEs. Regarding EU funds, they noted that Lithuania has one of the highest absorption rates in the EU. Finally, the authorities noted that raising the minimum wage could enhance labor supply incentives (as it is currently barely above the level of unemployment benefits), improve the reporting of wages for tax purposes, and help to reduce income inequality.

D. Euro Adoption

33. Staff supports the authorities' intention to meet the Maastricht criteria in 2012. The exchange rate arrangement (both de facto and de jure) is a currency board pegged to the euro. Meeting the fiscal deficit target for 2012 of 2.8 percent of GDP is an important step towards the MTO, as well as necessary to preserve euro adoption aspirations. With regard to the inflation criterion, price controls should not be used to reduce inflation.

Authorities' views

34. The authorities expressed their determination to meet the Maastricht criteria as soon as possible. They acknowledged that inflation could be above the criterion in 2012, but said that they had no intention of taking unorthodox measures to reduce inflation.

STAFF APPRAISAL

35. The economy has staged an impressive recovery, based on a supportive global environment and determined policy adjustment. Policy action included sizeable fiscal consolidation, the maintenance of confidence in the banking system, and significant wage adjustment that underpinned gains in competitiveness. After contracting sharply in 2008-09, economic activity grew modestly in 2010 and robustly in the first half of 2011. The export-led recovery broadened to domestic demand and employment growth accelerated.

36. With the worsening of external conditions, a further strengthening of policies is needed. As weaker demand from the euro area dampens export growth, and higher external financing costs are passed on to bank lending in Lithuania, economic growth will slow sharply in 2012. Risks to the economic outlook are clearly on the downside. An intensification of financial strains in Europe could lead to even weaker external demand and jeopardize funding.

37. Further fiscal consolidation is needed to preserve Lithuania's good fiscal record. The authorities' commitment to reducing the fiscal deficit to 2.8 percent of GDP in 2012 is welcome, though some of the proposed measures (such as extraordinary SOE dividends and land sales) do not appear to be sustainable. Also, in implementing spending cuts, it will be important to protect the most vulnerable people and preserve the level of public investment. Looking forward, expanding wealth taxation and broadening tax bases remain important options. Given the upside risk to the fiscal deficit stemming from the downside risk to economic growth, a contingency plan consisting of further measures should be prepared.

38. Important fiscal reforms already underway should be deepened. Given population aging, further reform of the pension system to ensure long-term sustainability is needed. The cost-benefit analysis of state-owned enterprises' social functions should be enhanced and governance reforms should be developed. Plans to further improve tax compliance are welcome. The role of independent evaluation in budget planning and execution could be expanded, and a strengthening of the existing expenditure rule could be considered.

39. The banking system as a whole appears well-positioned to withstand adverse shocks, but remaining pockets of weakness should be addressed without delay. The strong recovery has boosted banking system profitability; substantial increases in capital have raised the average capital adequacy ratio; and the average liquidity ratio is well above the regulatory minimum. Recent stress tests by the central bank show that the banking system as a whole is resilient to substantial shocks to capital and liquidity. However, some banks have made lower loan loss provisions than other banks, despite having higher NPL ratios. In these banks, it will be necessary to assess risks conservatively, to make appropriate loan loss provisions, and to increase capital if necessary. If the need arises, existing law provides the necessary authority to take adequate measures. In line with European and global initiatives, it is urgent to broaden the range of resolution tools.

40. The planned unification of financial supervision under the BOL will strengthen the authorities' ability to identify and address risks to the financial system. The head of supervision should report directly to the highest governing body of the central bank. In addition, the imminent introduction of responsible lending guidelines to contain systemic risk is welcome. To ensure that viable individual borrowers can recover and that creditors have adequate protection, an effective personal insolvency regime is needed.

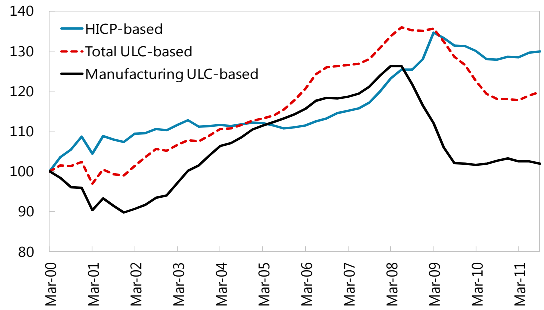
41. Sustainable growth over the medium term depends on increased labor participation, labor reallocation to tradable sectors, and strong investment. Greater use of fixed-term contracts could stimulate job creation. By contrast, raising the minimum wage at this juncture could slow job creation, reverse recent competitiveness gains, and increase government spending. Full use should be made of EU structural funds to overcome skill mismatches. To encourage investment, further efforts are needed to improve the business environment. The new law on business inspections and the proposed law on strengthening the role of the Competition Council are welcome.

42. It is proposed to hold the next Article IV consultation on the regular 12-month cycle.

Box 1. Real Exchange Rate Assessment

The depreciation of the real exchange rate since 2008–09 has mostly reflected significant nominal wage declines. Since the peak, the whole-economy ULC-based REER has depreciated by 12 percent, and the manufacturing ULC-based REER by 19 percent. The latter is now back to its 2000 level and some 11 percent below its 2005 level. The CPI-based REER has depreciated by less, as consumer prices declined less sharply than wages.

REER Index
(2000Q1=100)



Sources: EU Commission; and IMF staff calculations.

The real exchange rate is now assessed to be broadly in line with fundamentals. The average misalignment across the three CGER methods is not significantly different from zero. In the 2010 Article IV consultation, the CGER methods had found modest overvaluation, while a broader analysis (including unit labor costs) had suggested no competitiveness gap. As various measures of the real exchange rate have been broadly stable over the past year, this year's assessment is broadly consistent with last year's. Regarding the CGER methods, it is important to note that this year's computations of the current account norm and equilibrium exchange rate are based on a wider data set, and the estimates now impose multilateral consistency.

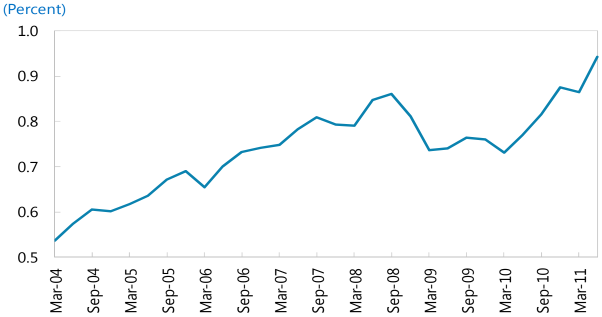
CGER-type Estimates of Misalignment
(Percent)

	2011	2010
Macroeconomic balance method	-2.7	-2.4
External sustainability method	1.2	6.4
Equilibrium exchange rate method	3.3	15.7
Average	0.6	6.6

Source: IMF staff calculations.

The assessment that there is no competitiveness gap at present is consistent with Lithuania's strong export performance. The share of Lithuania's exports in total EU exports has increased sharply over the past year and a half. Going forward, it will be important to avoid real exchange rate appreciation in order to maintain competitiveness in the face of significant challenges to medium-term sustainable growth.

Lithuania: Share of EU Exports 1/
(Percent)



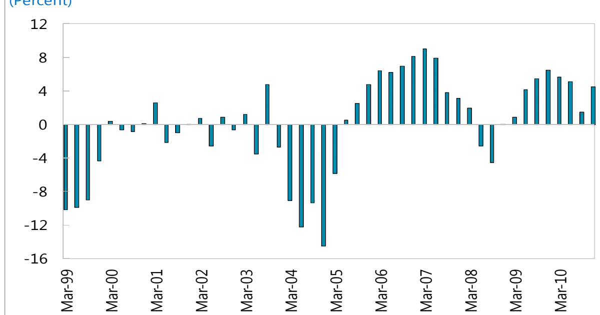
Source: Haver.
1/ Lithuania non-fuel exports as a percent of total EU exports.

Box 2. Time-Varying Tax Elasticities[1]

Historical, cross-country evidence suggests that tax revenues grow more quickly than their underlying bases during expansions and contract more sharply during recessions. The deviation of short-run tax elasticities from their long-run equilibriums can be driven by short-changes in the composition of tax bases and cyclical variations in tax compliance. In Lithuania, the VAT elasticity is especially important, as VAT revenue accounts for about half of total tax revenue. Staff analysis finds that the elasticity of VAT has fluctuated between 0.5 and 1.5 over the past decade.

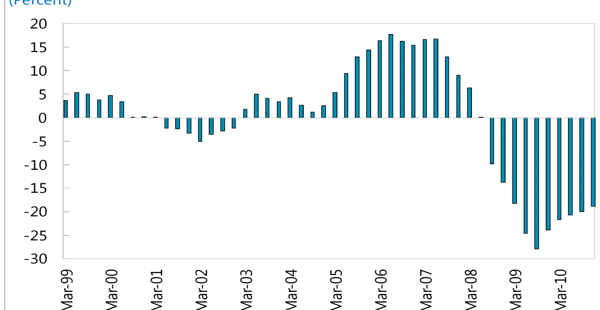
The recent strong growth of VAT revenue is consistent with an increasing short-run elasticity. Using a panel of 10 new EU member countries, staff analysis finds robust evidence of the long-run neutrality (i.e. unit elasticity) of VAT revenue with respect to private consumption (tax base). At the same time, the analysis finds that VAT revenue can and does deviate from its long-run value, with the deviation falling by about 10 percent each quarter (or 60 percent each year). According to the analysis, VAT revenues in Baltic countries deviated from their long-run levels during the recent boom and bust. At the peak of the boom, VAT collections exceeded their long-run equilibrium by about 20 percent in Latvia and 10 percent in Lithuania and Estonia. The gap turned negative in the aftermath of the crisis, particularly in Latvia and Lithuania, but is now closing again. In Lithuania, VAT revenue is estimated to have been about 5 percent below its long-run value at end-2010.

Estonia: Cyclical VAT Gap
(Percent)



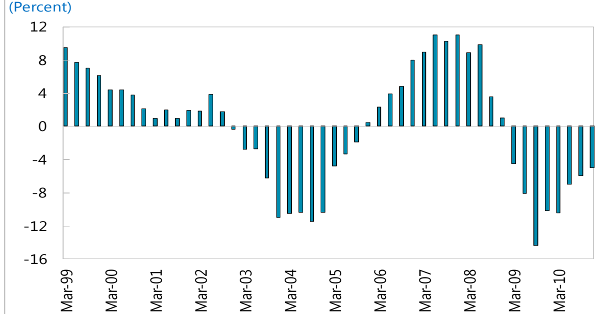
Sources: Ministry of Finance; and IMF staff calculations.

Latvia: Cyclical VAT Gap
(Percent)



Sources: Ministry of Finance; and IMF staff calculations.

Lithuania: Cyclical VAT Gap
(Percent)



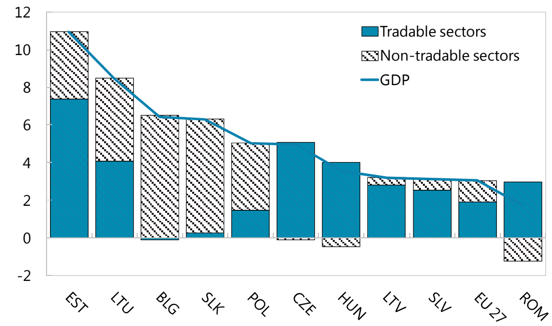
Sources: Ministry of Finance; and IMF staff calculations.

[1] See *Selected Issues Paper*, "Assessing the Variability of Tax elasticities in Lithuania".

Box 3. Rebalancing Growth[1]

After the boom in non-tradables ended in a crisis, will the economy rebalance towards export sectors? The post-crisis recovery has been very much export driven, and the contribution of tradable sectors to total growth, at some 50 percent, has been much higher than in the past. The impressive export performance has helped Lithuania achieve the second strongest recovery in central and eastern Europe after Estonia.

Contributions to Cumulative GDP Growth since Trough
(Percent)



Sources: Haver; and IMF staff calculations.

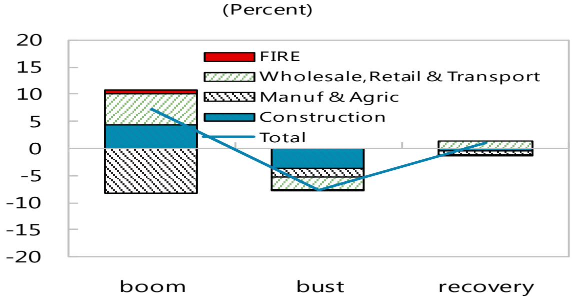
Is the export revival a product of temporary factors, or does it signal a more permanent reallocation of resources in the economy? Lithuanian exports have benefitted from temporary factors, including increases in the global prices of key exports (especially food products and fertilizers) that could easily reverse. Signs of a more sustained reallocation are mixed:

- *Labor*: with the exception of the transportation sector, tradable sectors have generally not contributed more to employment growth than non-tradable sectors. It may be that exporting firms are uncertain about prospects, so are delaying hiring new workers.

- *FDI:* while net FDI as a percent of GDP is lower than before the crisis, the composition of FDI has shifted towards tradable sectors. FDI flows into real estate or financial intermediation have fallen by some 2½ percentage points of GDP relative to pre-crisis levels, but flows into manufacturing have stayed constant.

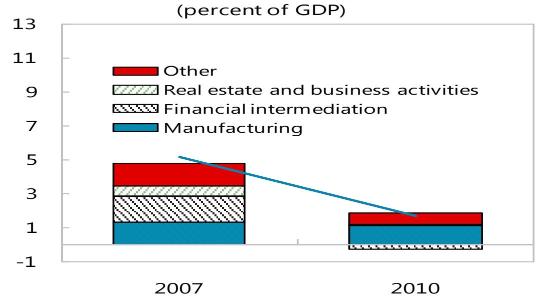
In short, there are early signs of a reallocation of resources towards tradable sectors, but this is not yet firmly entrenched. Going forward, it will be important to ensure that competitiveness is not eroded.

Contribution to Total Employment by Sector
(Percent)



Source: Eurostat; and IMF staff calculations.

FDI Allocation, 2007 and 2010
(percent of GDP)



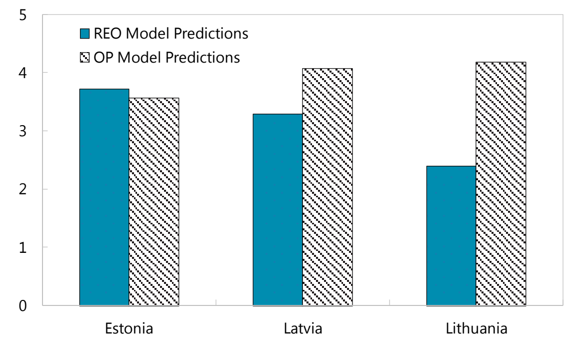
Source: Central Banks and national statistical offices

[1] See *Selected Issues Paper*, "The Strength and Sustainability of the Recovery".

Box 4. Medium-Term Growth Prospects[1]

Medium-term growth rates in the Baltic countries will likely be lower than before the 2008–09 crisis. Empirical specifications based on the growth literature, which link economic growth to variables such as initial income, investment, education, institutional quality, and quality of macroeconomic policies, suggest that medium-term growth rates in the Baltic countries will be in the range of 3¼–4¼ percent. This is 4–5 percentage points lower than during the 2002–07 boom, a decline which is due to the following factors:

Medium-term Growth: Model Predictions
(Percent per year)



Sources: WEO; and IMF staff calculations.

- *Growth during the boom was unsustainably high*. Estimating the same models in 2002 would have predicted growth rates about 2–2½ percentage points below actual growth during the boom.

- *Baltic countries are wealthier today than they were in the early 2000s*. In all three Baltic countries, income per capita was higher in 2010 than in the early 2000s, despite the collapse in output over 2008–09. Given conditional convergence (the phenomenon that *ceteris paribus* poorer countries tend to grow faster than richer countries), the Baltic countries should be expected to grow more slowly going forward. Econometric estimates suggest that the convergence effect accounts for about ¾ percentage point of the projected decline in growth.

- *Investment has fallen*. In the Baltics, investment ratios were artificially boosted during the boom, but these gains were more than fully wiped out by the crisis. The decline in investment has not been limited to construction: non-construction investment also plummeted and is now about half the level seen over much of the last 15 years. Experience from countries with similar boom-bust cycles suggests investment could be slow to recover. If investment today was at 1998 levels, *ceteris paribus*, yearly predicted growth would be 1 percentage point higher in Latvia and Lithuania, and 1¾ percentage points in Estonia.

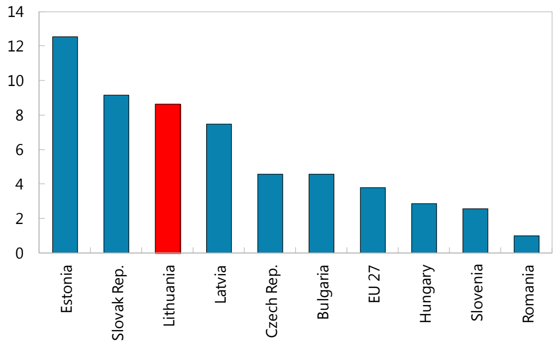
Lower investment will imply slower growth of labor productivity and hence a slower catch-up of living standards with the EU average. Labor productivity is projected to grow between 3¼–3¾ percentage points more slowly than during the boom years. And the slowdown in labor productivity will come at a time when the labor force is expected to shrink due to population aging and emigration. Sustaining even 4 percent GDP growth will thus require large increases in employment ratios.

[1] See *Selected Issues Paper*, "How Fast Can the Baltics Grow in the Medium Term?"

Figure 1. Real and External Developments

Lithuania has staged an impressive recovery...

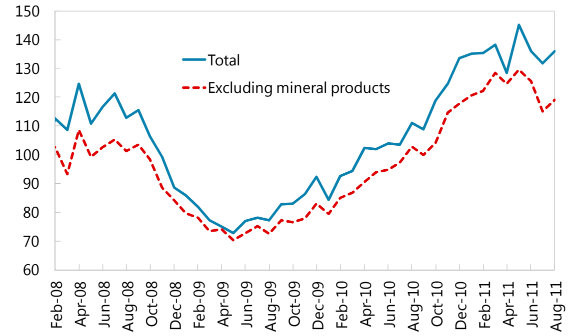
Economic Recovery in Selected European Countries
(Cumulative growth from trough to the latest quarter, SA, in percent)



Sources: Haver; and Fund staff calculations.

...on the back of strong exports.

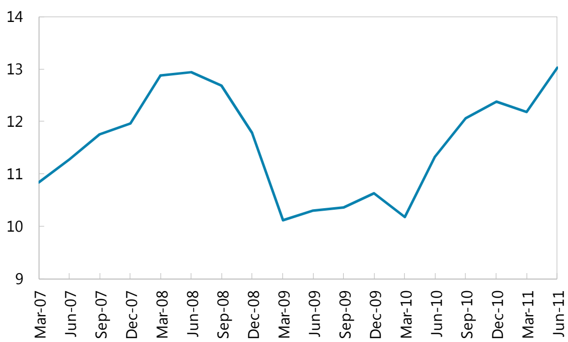
Exports of Goods, SA
(Jan. 2008=100)



Sources: Haver; and Statistics Lithuania.

This has boosted corporate profitability...

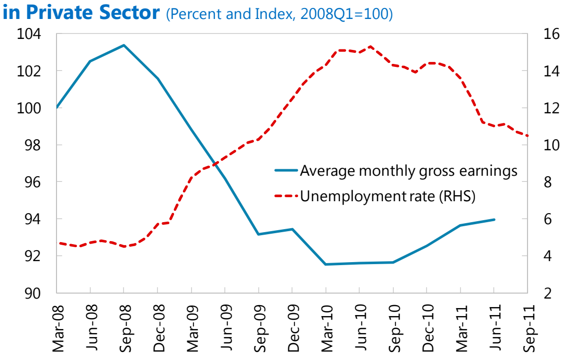
Operating Surplus and Mixed Income, SA
(Billions of litas)



Sources: Haver; and European Commission.

...and helped stabilize the labor market.

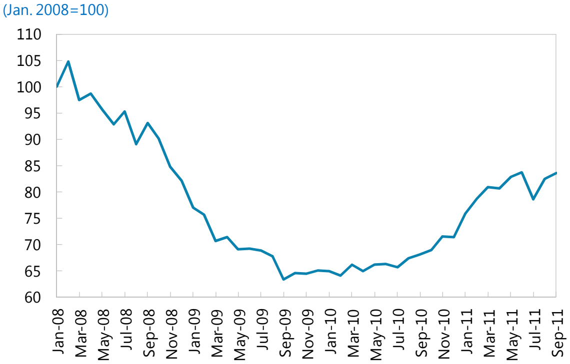
Unemployment Rate and Average Monthly Gross Earnings in Private Sector (Percent and Index, 2008Q1=100)



Sources: Haver; and Lithuanian Labor Exchange.

As a result, domestic demand is rebounding...

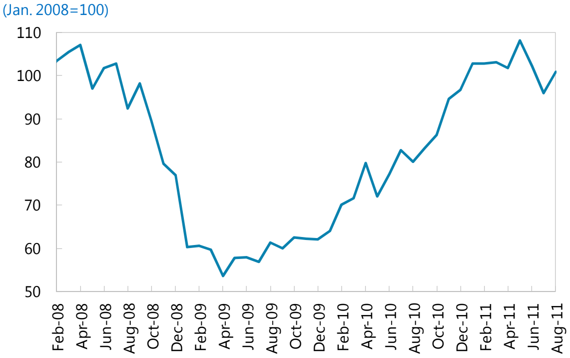
Retail sales, SA
(Jan. 2008=100)



Sources: Haver; and IMF staff calculations.

...which, together with higher food and energy prices, has pushed imports up strongly.

Imports of Goods, SA
(Jan. 2008=100)



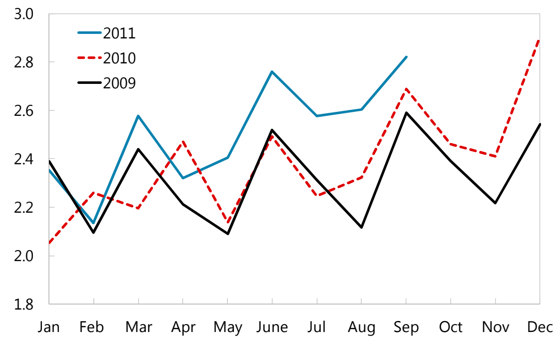
Sources: Haver; and IMF staff calculations.

Figure 2. Fiscal Developments

The economic recovery is boosting fiscal revenues…

Central Government Revenues

(Billions litas)

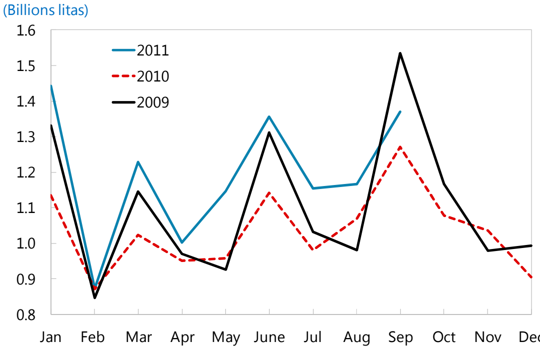


Sources: Ministry of Finance; and IMF staff calculations.

…notably VAT and excises.

Central Government Taxes

(Billions litas)

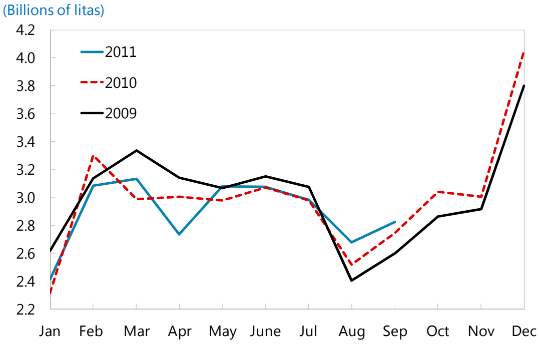


Sources: Ministry of Finance; and IMF staff calculations.

Moreover, the government continues to exercise expenditure restraint…

Central Government Total Spending

(Billions of litas)

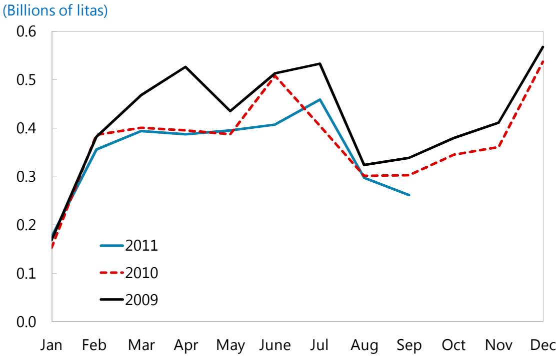


Sources: Ministry of Finance; and IMF staff calculations.

…not least over the public wage bill.

Central Government Compensation of Employees

(Billions of litas)

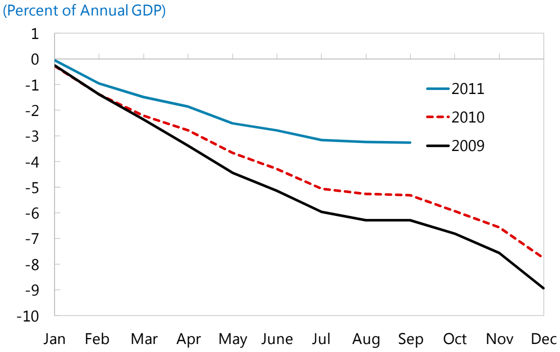


Sources: Ministry of Finance; and IMF staff calculations.

Higher revenues and capped expenditures are contributing towards significantly lower deficits…

Cumulative Central Government Balance 1/

(Percent of Annual GDP)

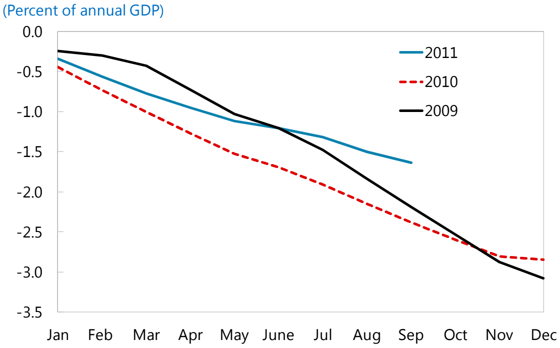


Sources: Ministry of Finance; and IMF staff calculations.
1/ The annual GDP used for 2011 is from latest IMF staff forecast.

…including in the social security fund.

Cumulative Sodra Deficit 1/

(Percent of annual GDP)

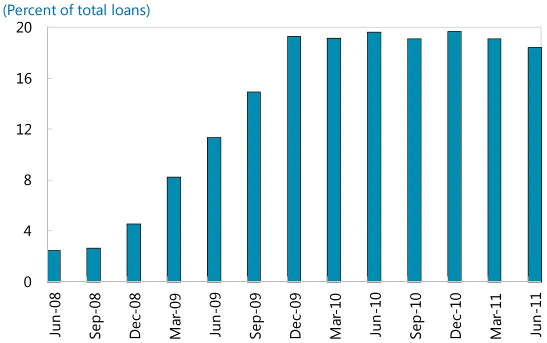


Sources: Ministry of Finance; and IMF staff calculations.
1/ The annual GDP used for 2011 is from latest IMF staff forecast.

Figure 3. Money and Banking

NPLs have stabilized…

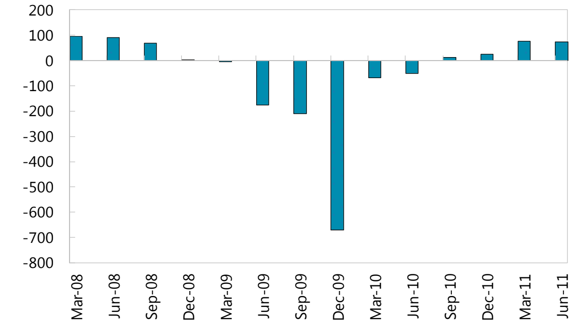
Non-Performing Loan Ratio
(Percent of total loans)



Sources: Bank of Lithuania; and IMF staff calculations.

…which, together with higher interest margins, has brought the banks back into profitability.

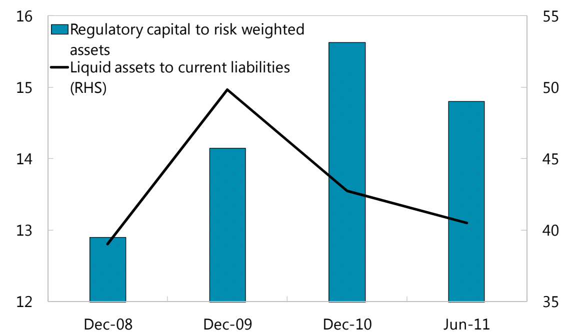
Quarterly Profits of Banks
(Millions of euro)



Sources: Association of Lithuanian Banks; and IMF staff calculations.

On the whole, aggressive provisioning and recapitalization have left the system in good shape…

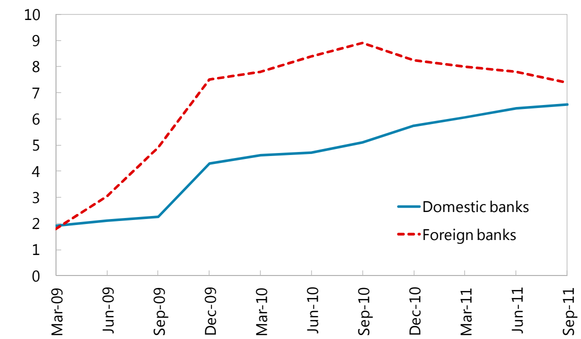
Capital Adequacy and Liquidity Ratios
(Percent)



Sources: Bank of Lithuania; and IMF staff calculations.

…with the weaker banks now slowly increasing provisions.

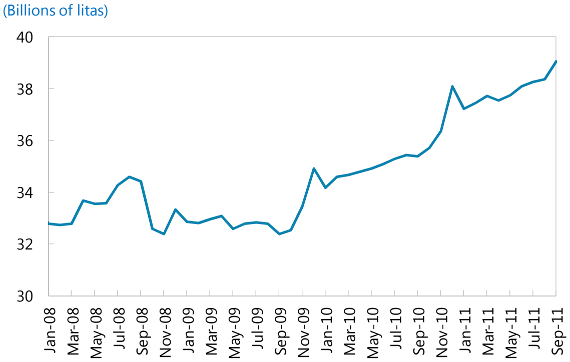
Provisions for Bad Loans
(Percent of total loans)



Sources: Bank of Lithuania; and IMF staff calculations.

The economic recovery and improvements in the banks have led to an increase in deposits…

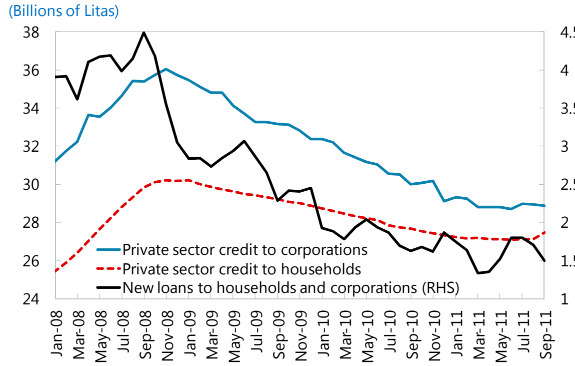
Deposits of Corporations and Households
(Billions of litas)



Sources: Bank of Lithuania; and IMF staff calculations.

…but credit remains depressed as households and firms gradually repair their balance sheets.

Credit and New Loans
(Billions of Litas)



Sources: Bank of Lithuania; and IMF staff calculations.

Table 1. Lithuania: Selected Economic and Social Indicators, 2009–16

Population (2010): 3.293 million
GDP per capita (2010): U$D 11,004
Life expectancy at birth (2009): 78.3 years (women), 67.5 years (men)
At-risk-of-poverty, share of population (2010): 33.4 percent

	2009	2010	2011	2012	2013	2014	2015	2016
			Projections					
Real economy								
Nominal GDP (in billions of litai)	91.9	95.1	106.8	114.4	122.3	130.8	139.4	148.5
GDP (in billions of euros)	26.6	27.5	30.9	33.1	35.4	37.9	40.4	43.0
Real GDP (annual percentage change)	-14.8	1.4	6.3	3.5	3.7	3.8	3.8	3.8
CPI, period average (annual percentage change)	4.2	1.3	4.3	3.1	2.7	2.5	2.4	2.2
CPI, end of period (year-on-year percentage change)	1.2	3.8	3.8	2.7	2.5	2.5	2.3	2.2
Average monthly gross earnings (annual percentage change)	-4.4	-3.9	3.3	4.1	4.7	4.6	5.0	5.3
Average monthly gross earnings (eop, annual percentage change) 1/	-8.7	0.2	2.5	...	...	...	...	...
Unemployment rate (year average, in percent of labor force)	13.7	17.8	15.5	14.0	12.0	10.0	8.5	8.0
Saving-investment balance (in percent of GDP)								
Gross national saving	14.8	17.7	18.2	19.6	19.5	19.6	19.2	19.3
Gross national investment	10.4	16.2	19.6	21.4	22.0	22.7	23.3	23.9
Foreign net savings	-4.4	-1.5	1.3	1.8	2.5	3.1	4.1	4.6
Fiscal sector (in percent of GDP)								
General government balance	-9.5	-7.1	-5.1	-2.8	-2.5	-2.0	-1.7	-1.5
Revenue	34.3	33.8	32.8	34.0	33.5	33.0	32.6	32.3
Of which EU grants	1.7	2.7	2.7	2.9	2.6	2.3	1.7	1.4
Expenditure	43.8	40.9	37.9	36.8	35.9	35.0	34.3	33.8
Of which: Non-interest	42.5	39.1	36.0	35.1	34.1	33.2	32.5	32.0
Interest	1.3	1.8	1.9	1.8	1.8	1.8	1.8	1.8
General government gross debt (Maastricht definition)	29.4	38.0	37.5	38.8	38.7	38.2	37.6	36.8
Of which: Foreign currency-denominated	27.0	34.2	32.2	32.6	31.8	30.6	30.1	29.4
External sector (in percent of GDP, unless otherwise specified)								
Current account balance								
in percent of GDP	4.4	1.5	-1.3	-1.8	-2.5	-3.1	-4.1	-4.6
in billions of euros	1.2	0.4	-0.4	-0.6	-0.9	-1.2	-1.7	-2.0
Exports of goods and services (volume change, in percent)	-12.5	17.4	13.8	5.5	6.5	6.7	6.6	6.7
Imports of goods and services (volume change, in percent)	-28.3	17.3	14.6	7.1	7.5	7.5	7.3	7.1
Foreign direct investment, net	-0.5	1.8	2.9	3.2	3.4	3.6	3.5	3.5
Gross official reserves (in billions of euros)	4.7	5.2	5.6	6.2	6.5	7.1	7.3	7.5
Reserve cover in months of imports of goods and services	3.8	3.2	2.8	2.9	2.8	2.9	2.8	2.7
Reserve cover in percent of short-term debt at remaining maturity	42.1	58.9	47.0	51.8	59.5	58.0	56.8	55.8
Gross external debt 2/	87.0	87.4	76.6	72.1	67.0	63.9	61.6	59.8
Short-term debt at original maturity	15.8	15.3	14.5	14.8	15.3	15.8	16.4	16.9
Exchange rates								
Exchange rate (litai per U.S. dollar, end of period)	2.40	2.61	...	...	...	...	...	...
Exchange rate (litai per U.S. dollar, period average)	2.48	2.61	...	...	...	...	...	...
Exchange rate (litai per euro, end of period)	3.45	3.45	...	...	...	...	...	...
Real effective exchange rate (2005=100, increase=appreciation) 3/	118.4	113.2	114.9	...	...	...	...	...
Money and credit								
Reserve money (end of period, percent change)	-17.2	19.4	2.7	7.5	...	...	...	...
Broad money (end of period, percent change)	0.3	8.9	8.9	14.3	...	...	...	...
Private sector credit (end of period, percent change)	-6.9	-7.6	-1.7	4.5	...	...	...	...
Currency outside banks, in percent of deposits	19.0	19.7	20.5	20.0	...	...	...	...

Sources: Lithuanian authorities; World Bank; Eurostat; and IMF staff estimates and projections.
1/ For 2011, second quarter data.
2/ Government external debt here includes guaranteed loans.
3/ CPI-based, 2005 trade-weighted real effective exchange rate against 17 major trading partners. For 2011, average January-August.

Table 2. Lithuania: Medium Term Framework, 2009–16

	2009	2010	2011	2012	2013	2014	2015	2016
			Projections					
Real economy								
Real GDP (annual percentage change)	-14.8	1.4	6.3	3.5	3.7	3.8	3.8	3.8
CPI, period average (annual percentage change)	4.2	1.3	4.3	3.1	2.7	2.5	2.4	2.2
Average monthly gross earnings (annual percentage change)	-4.4	-3.9	3.3	4.1	4.7	4.6	5.0	5.3
Unemployment rate (year average, in percent of labor force) 1/	13.7	17.8	15.5	14.0	12.0	10.0	8.5	8.0
Saving-investment balance (in percent of GDP)								
Gross national saving	14.8	17.7	18.2	19.6	19.5	19.6	19.2	19.3
Gross national investment	10.4	16.2	19.6	21.4	22.0	22.7	23.3	23.9
Foreign net savings	-4.4	-1.5	1.3	1.8	2.5	3.1	4.1	4.6
Fiscal sector (in percent of GDP)								
General government balance	-9.5	-7.1	-5.1	-2.8	-2.5	-2.0	-1.7	-1.5
General government gross debt (Maastricht definition)	29.4	38.0	37.5	38.8	38.7	38.2	37.6	36.8
External sector (in percent of GDP, unless otherwise specified)								
Current account balance	4.4	1.5	-1.3	-1.8	-2.5	-3.1	-4.1	-4.6
Gross official reserves (in billions of euros)	4.6	5.2	5.6	6.2	6.5	7.1	7.3	7.5
Reserve cover of short-term debt at remaining maturity	42.1	58.9	47.0	51.8	59.5	58.0	56.8	55.8
Gross external debt 2/	87.0	87.4	76.6	72.1	67.0	63.9	61.6	59.8
Short-term debt at original maturity	15.6	15.3	14.5	14.8	15.3	15.8	16.4	16.9
Exchange rates								
Real effective exchange rate (2005=100, increase=appreciation) 3/	118.4	113.2	114.9	...	...	...	...	...
Money and credit								
Reserve money (end of period, percent change)	-17.2	19.4	2.7	7.5	...	...	...	...
Broad money (end of period, percent change)	0.3	8.9	8.9	14.3	...	...	...	...
Private sector credit (end of period, percent change)	-6.9	-7.6	-1.7	4.5	...	...	...	...
Currency outside banks, in percent of deposits	19.0	19.7	20.5	20.0	...	...	...	...
Foreign-currency deposits (percent of total deposits)	32.0	28.6	31.0	31.0	...	...	...	...
Foreign-currency loans (percent of total loans)	73.5	74.6	74.0	74.0	...	...	...	...
Social indicators								
Population (in thousands)	3339	3293	3273	3253	3234	3214	3198	3183
GDP per capita (in U.S. dollars)	11638	11054	13420	14319	15290	16317	17341	18413

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

1/ Based on labor force survey data.

2/ Government external debt here includes guaranteed loans.

3/ CPI-based, 2005 trade-weighted real effective exchange rate against 17 major trading partners. For 2011, average January-August.

Table 3. Lithuania: Balance of Payments, 2009–16

(In billions of euros, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014	2015	2016
			Projections					
Current account balance	1.2	0.4	-0.4	-0.6	-0.9	-1.2	-1.7	-2.0
Merchandise trade balance	-0.9	-1.3	-1.3	-1.4	-1.6	-1.8	-2.0	-2.3
Exports (f.o.b.)	11.8	15.7	20.3	21.7	23.4	25.0	26.7	28.7
Imports (f.o.b.)	-12.6	-16.9	-21.7	-23.1	-25.0	-26.7	-28.7	-31.0
Services balance	0.5	1.0	0.9	1.0	1.1	1.1	1.2	1.3
Exports of non-factor services	2.7	3.1	3.4	3.5	3.7	3.9	4.1	4.3
Imports of non-factor services	-2.1	-2.1	-2.5	-2.6	-2.7	-2.8	-2.9	-3.0
Factor income balance	0.4	-0.6	-1.3	-1.5	-1.7	-1.8	-2.0	-2.1
Receipts	0.6	0.5	0.6	0.6	0.7	0.7	0.8	0.8
Payments	-0.2	-1.2	-1.9	-2.1	-2.3	-2.5	-2.8	-3.0
Current transfer balance	1.2	1.3	1.3	1.4	1.3	1.3	1.1	1.1
Capital and financial account balance	-1.2	0.1	0.8	1.2	1.2	1.7	1.9	2.2
Capital transfer balance	0.9	0.7	0.7	0.7	0.6	0.6	0.5	0.5
Foreign direct investment balance 1/	-0.1	0.5	0.9	1.1	1.2	1.4	1.4	1.5
Portfolio investment balance 1/	0.8	1.4	-0.1	0.0	-0.4	-0.5	-0.4	-0.5
Other investment balance 1/	-2.8	-2.5	-0.6	-0.5	-0.1	0.3	0.5	0.8
Errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-0.1	0.5	0.4	0.6	0.3	0.5	0.2	0.3
Financing	0.1	-0.5	-0.4	-0.6	-0.3	-0.5	-0.2	-0.3
Gross international reserves (increase: -)	0.1	-0.5	-0.4	-0.6	-0.3	-0.5	-0.2	-0.3
In percent of GDP (unless indicated)								
Current account balance	4.4	1.5	-1.3	-1.8	-2.5	-3.1	-4.1	-4.6
Trade Balance of goods and services	-1.3	-1.1	-1.3	-1.4	-1.5	-1.7	-2.0	-2.2
Exports	54.3	68.2	76.7	76.2	76.4	76.2	76.2	76.7
Imports	-55.6	-69.2	-78.0	-77.5	-78.0	-77.9	-78.2	-78.9
Factor Income	1.3	-2.3	-4.3	-4.5	-4.7	-4.8	-4.9	-5.0
Current Transfers	4.4	4.8	4.4	4.1	3.7	3.3	2.8	2.6
Capital and financial account balance	-4.7	0.4	2.7	3.7	3.5	4.5	4.6	5.2
Capital transfers	3.4	2.7	2.4	2.2	1.7	1.5	1.2	1.2
Foreign direct investment balance	-0.4	1.8	2.9	3.2	3.4	3.6	3.5	3.5
Portfolio investment balance	2.9	5.1	-0.4	-0.1	-1.2	-1.2	-1.1	-1.2
Other investment balance	-10.7	-9.0	-2.0	-1.4	-0.2	0.9	1.3	1.9
Overall balance	-0.2	1.9	1.4	1.9	1.0	1.4	0.5	0.6
Gross external debt 1/	87.0	87.4	76.6	72.1	67.0	63.9	61.6	59.8
Public	20.8	30.2	28.1	27.8	26.2	24.2	22.2	20.1
Short-term	0.5	0.7	0.7	0.7	0.7	0.8	0.8	0.8
Long-term	20.3	29.5	27.4	27.1	25.4	23.5	21.4	19.3
Private	66.2	57.2	48.6	44.3	40.8	39.7	39.4	39.7
Short-term	20.6	20.6	19.2	19.2	19.4	19.7	20.0	20.4
Long-term	45.6	36.6	29.3	25.1	21.4	20.0	19.4	19.4
Gross external debt (in percent of GNFS export	160.3	128.3	100.0	94.7	87.7	83.9	80.8	78.0
Net external Debt	40.6	39.7	32.5	29.5	27.6	26.3	26.5	27.0
Net international investment position	-59.4	-55.8	-48.5	-44.9	-42.8	-41.7	-42.0	-42.9
GIR (in billions of Euros)	4.6	5.2	5.6	6.2	6.5	7.1	7.3	7.5
GIR (in percent of short-term debt) 2/	42.1	58.9	47.0	51.8	59.5	58.0	56.8	55.8
GIR (in months of imports of goods and service	3.8	3.2	2.8	2.9	2.8	2.9	2.8	2.7
Merchandise export volume (percent change)	-12.5	17.4	13.8	5.5	6.5	6.7	6.6	6.7
Merchandise import volume (percent change)	-28.3	17.3	14.6	7.1	7.5	7.5	7.3	7.1
Merchandise export prices (percent change)	-14.4	10.6	14.2	1.1	1.0	0.2	0.3	0.7
Merchandise import prices (percent change)	-10.4	9.7	11.8	-0.5	0.4	-0.3	0.2	0.7
GDP (in billion of Euros)	26.6	27.5	30.9	33.1	35.4	37.9	40.4	43.0

Sources: Data provided by the Lithuanian authorities; IMF International Financial and Trade Statistics; and Fund staff estimates and projections.

1/ Government external debt here includes guaranteed loans.

2/ Short-term debt at remaining maturity.

Table 4. Lithuania: General Government Operations, 2009-16

(ESA 95 aggregates, in percent of GDP)

	2009	2010	2011	2012	2013	2014	2015	2016
			Forecasts					
Statement of Operations								
Revenue	34.3	33.8	32.8	34.0	33.5	33.0	32.6	32.3
Revenue excluding EU grants	32.7	31.2	30.1	31.1	30.9	30.8	30.9	30.9
Tax revenue	17.4	16.5	16.2	16.3	16.4	16.6	16.7	16.8
Direct taxes	6.0	4.7	4.6	4.6	4.7	4.8	4.9	4.9
Personal income tax	4.1	3.6	3.4	3.5	3.5	3.5	3.6	3.6
Corporate income tax	1.9	1.0	1.1	1.2	1.2	1.2	1.2	1.2
Indirect taxes	11.4	11.8	11.6	11.7	11.7	11.8	11.8	11.9
VAT	7.2	7.8	7.8	7.8	7.8	7.8	7.8	7.8
Excises	3.5	3.2	2.9	3.0	3.1	3.1	3.1	3.2
Other	0.7	0.8	0.8	0.8	0.9	0.9	0.9	0.9
Social contributions	12.1	10.7	10.1	10.1	10.1	10.2	10.2	10.1
Grants	1.7	2.7	2.7	2.9	2.6	2.3	1.7	1.4
Other revenue	3.2	3.9	3.8	4.7	4.3	4.1	4.1	4.1
Total expenditure	43.8	40.9	37.9	36.8	35.9	35.0	34.3	33.8
Current spending	39.9	36.4	34.1	32.7	31.9	31.3	30.8	30.4
Compensation of employees	12.9	11.1	10.2	9.3	9.1	8.9	8.8	8.7
Goods and services	5.8	6.4	5.7	5.4	5.5	5.5	5.5	5.5
Interest payments	1.3	1.8	1.9	1.8	1.8	1.8	1.8	1.8
Foreign	0.7	1.2	1.4	1.2	1.2	1.2	1.1	1.0
Domestic	0.5	0.7	0.5	0.5	0.6	0.7	0.7	0.8
Subsidies	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.4
Grants	0.9	0.7	0.7	0.6	0.6	0.6	0.4	0.4
Social benefits	17.2	14.9	13.9	13.9	13.3	12.8	12.7	12.5
Other expense	1.2	1.0	1.1	1.1	1.1	1.1	1.1	1.1
Capital spending	3.9	4.5	3.8	4.2	4.0	3.8	3.5	3.4
Net lending (+) / borrowing (-) 1/	-9.5	-7.1	-5.1	-2.8	-2.5	-2.0	-1.7	-1.5
Net acquisition of financial assets	2.0	2.5	-1.9	1.0	0.0	0.0	0.0	0.0
Domestic	0.9	0.8	-1.3	0.0	0.0	0.0	0.0	0.0
Foreign	1.1	1.7	-0.6	1.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	11.5	9.5	3.2	3.8	2.5	2.0	1.7	1.5
Domestic	2.6	1.0	2.1	2.3	2.3	2.3	2.3	2.3
Foreign	8.8	8.6	1.1	1.5	0.1	-0.3	-0.6	-0.8
Financial Balance Sheet								
Financial assets	33.1	33.7	...	...	...	...	...	...
Currency and deposits	6.8	7.9	...	...	...	...	...	...
Securities other than shares	0.2	0.1	...	...	...	...	...	...
Loans	1.2	1.1	...	...	...	...	...	...
Shares and other equity	21.2	19.6	...	...	...	...	...	...
Other financial assets	3.7	5.0	...	...	...	...	...	...
Financial liabilities	35.6	46.6	...	...	...	...	...	...
Currency and deposits	0.0	0.0	...	...	...	...	...	...
Securities other than shares	25.2	34.3	...	...	...	...	...	...
Loans	4.8	6.9	...	...	...	...	...	...
Other liabilities	5.7	5.4	...	...	...	...	...	...
Net financial worth	-2.6	-12.9	...	...	...	...	...	...
Memorandum items:								
GDP (in millions of litai)	91,914	95,074	106,848	114,367	122,344	130,822	139,428	148,494
General government debt (Maastricht definition)	29.4	38.0	37.5	38.8	38.7	38.2	37.6	36.8
Foreign debt	20.7	28.3	26.3	26.1	24.5	22.6	20.6	18.5
Domestic debt	8.6	9.7	11.1	12.7	14.2	15.6	17.0	18.3
Net lending (+) / borrowing (-) net of pillar II transfer cuts 1/	-10.0	-7.7	-5.7	-3.4	-3.0	-2.5	-2.3	-2.0

Sources: Ministry of Finance; Ministry of Social Security; and IMF staff estimates.

1/ General government deficit including payments not transferred by SODRA to private pension accounts. For 2012 and beyond, the forecast assumes the planned restoration of pensions to pre-crisis levels.

Table 5. Lithuania: Possible Revenue Measures

Instrument	Proposed amendment	Short-term	Medium-term
		Annual Yield (% of GDP) 1/	
Property and Wealth Taxes	Introduce immovable property tax on private residential housing	0.4	0.4
	Annual car license fee graduated per engine capacity	0.3-0.5	0.3-0.5
	Increase the charge on commercial vehicles based on gross laden weight	0.1	0.1
	Expand land taxation	0.1	0.1
Corporate Income Tax	Withdraw the investment incentive	0.3	0.3
	Withdraw preferential rate on small companies, remove 6 year tax relief in free economic zones and shorten duration for preferential rate	0.1-0.3	0.1-0.3
	Strengthen thin capitalization rule		
Personal Income Tax	Subject all pension payments to income tax	0.5	0.5
	Consider removal of child allowances	0.1	0.1
Social contributions	Strengthen the contributions base to include all earnings categories (self-employed, farmers, authors etc. covered at rate 37.5%)	0.3	0.3
Revenue administration	Tighten border control	0.2	>0.7
	Expand use of cash registers in trading markets		
	Mandatory declaration of income		
	Life-style surveys		
Total savings capacity		2.4 - 2.8	2.9 - 3.3

Source: IMF Staff estimates.

1/ Estimated yields for the proposed measures are mutually exclusive.

Table 6. Lithuania: Summary of Monetary Accounts, 2009–12
(In billions of litai; unless otherwise specified)

	2009	2010	2011	2012
			Projections	
Monetary Authority				
Gross foreign assets	15.8	17.8	19.3	21.4
Gross foreign liabilities	0.4	0.6	0.6	0.6
Of which: Use of Fund credit	2.0	5.0	0.0	0.0
Of which: Nonresident deposits	0.4	0.6	0.6	0.6
Net foreign assets	15.4	17.2	18.7	20.9
Gold	0.5	0.7	…	…
Net domestic assets	-4.9	-4.7	-4.2	-4.2
Net credit to government	-2.6	-2.4	-2.0	-2.0
Credit to banks	0.0	0.0	0.0	0.0
Credit to private sector	0.0	0.0	0.0	0.0
Credit to non-bank financial institutions	…	…	…	…
Other items, net	-2.3	-2.2	-2.2	-2.2
Reserve money	10.5	12.6	12.9	13.9
Currency outside the central bank	7.9	8.8	9.8	10.9
Currency outside banks	7.0	7.8	8.9	10.0
Cash in vaults of banks	1.0	1.0	0.9	0.9
Deposit money banks' deposits	2.6	3.8	3.1	3.0
Banking Survey				
Net foreign assets	-5.6	1.4	4.4	7.0
Monetary authority	15.4	17.2	18.7	20.9
Banks and other banking institutions	-21.1	-15.8	-14.3	-13.8
Net domestic assets	49.8	46.7	48.0	52.9
Net claims on government 1/	-2.6	0.7	3.5	6.1
Monetary authority	-2.6	-2.4	-2.0	-2.0
Banks and other banking institutions	0.1	3.1	5.5	8.1
Credit to private sector	61.4	56.8	55.8	58.3
Credit to nonbank financial institutions	2.7	3.7	4.2	4.5
Other items, net	-11.8	-14.4	-15.5	-16.0
Broad money	44.2	48.1	52.4	59.9
Currency outside banks	7.0	7.8	8.9	10.0
Deposits	36.8	39.9	43.5	49.9
In national currency	25.0	28.5	30.0	34.4
Savings deposits	13.6	13.0	13.7	15.7
Demand deposits	11.4	15.5	16.3	18.7
In foreign currency	11.8	11.4	13.5	15.5
Memorandum items:				
Reserve money (yearly percent change)	-17.2	19.4	2.7	7.5
Broad money (yearly percent change)	0.3	8.9	8.9	14.3
Private sector credit (yearly percent change)	-6.9	-7.6	-1.7	4.5
Money multiplier	4.2	3.8	4.1	4.3
Currency outside banks, in percent of deposits	19.0	19.7	20.5	20.0
Foreign-currency deposits (percent of total deposits)	32.0	28.6	31.0	31.0
Foreign-currency loans (percent of total loans) 2/	73.5	74.6	74.0	74.0
Velocity of broad money	2.1	2.0	2.0	1.9
Gross official reserves (billions of U.S. dollars) 3/	6.7	6.8	7.9	8.7
Gross official reserves (billions of euros) 3/	4.6	5.2	5.6	6.2
Excess reserve coverage 4/	14.5	13.1	14.6	15.1
GDP	91.9	95.1	106.8	114.4

Sources: Bank of Lithuania; and Fund staff estimates and projections.
1/ Excludes local government deposits; includes counterpart funds.
2/ Loans to households and non-financial corporations.
3/ BOP basis. Differs from gross foreign assets as shown in the monetary authority's balance sheet because of (BOP-basis official reserves include accrued interest on deposits and securities but exclude investments in shares and other equity).
4/ Bank of Lithuania's gross foreign assets less reserve money, in percent of banking system deposits.

Table 7: Financial Soundness Indicators, 2007 - 2011, Banking System Data

	2007	2008	2009	2010	June 2011
Capital adequacy					
Regulatory capital to risk-weighted assets [1, 9]	10.9	12.9	14.2	15.6	14.8
Regulatory Tier 1 capital to risk-weighted assets [1, 9]	7.7	10.2	10.4	11.6	11.4
Capital to assets [1]	7.9	9.2	7.9	8.9	9.9
Asset quality					
Nonperforming loans to capital [1, 3]	10.0	...	...	...	...
Nonperforming loans net of provisions to capital [1, 3, 12, 13, 14]	2.9	...	...	...	...
Nonperforming loans to total (non-interbank) loans [3]	1.0	...	...	...	...
Nonperforming loans to capital [1, 4]	...	42.4	202.9	179.9	144.8
o/w impaired loans to capital [1, 4]	...	31.8	168.6	151.0	120.3
o/w non-impaired loans overdue more than 60 days to capital [1, 4]	...	10.7	34.4	28.9	24.5
Nonperforming loans net of provisions to capital [1, 4, 14]	...	31.6	128.5	109.1	86.4
Nonperforming loans to total (non-interbank) loans [4]	...	4.6	19.3	19.7	18.4
o/w impaired loans to total (non-interbank) loans [4]	...	3.4	15.8	16.7	15.4
o/w non-impaired loans overdue more than 60 days to total (non-interbank) loans [4]	...	1.1	3.5	3.0	3.0
Impairment losses to total (non-interbank) loans[12, 14]	0.74	1.20	7.2	7.9	7.55
Impairment losses to nonperforming loans [3, 4, 12, 14]	72.2	26.46	37.1	40.2	41.1
Sectoral distribution of loans to total loans [6]					
Agriculture, hunting, forestry	1.7	2.1	1.9	1.9	1.9
Fishing	0.0	0.0	0.0	0.0	0.0
Mining and quarrying	0.1	0.2	0.2	0.3	0.1
Manufacturing	9.9	10.7	10.3	9.4	9.4
Electricity, gas and water supply	2.2	1.9	1.9	2.1	2.1
Construction	4.1	3.8	3.1	2.9	2.9
Wholesale and retail trade	10.7	10.7	9.7	8.8	8.9
Hotels and restaurants	1.4	1.6	1.7	1.5	1.5
Transport, storage and communication	2.2	2.5	2.6	2.3	2.2
Financial intermediation	5.5	6.3	4.0	5.6	5.8
Real estate, renting and other business activities	16.8	18.4	20.2	19.1	19.0
Public administration and defence; compulsory social security	1.3	2.1	2.2	3.7	3.8
Education	0.0	0.3	0.1	0.1	0.1
Health and social work	0.3	0.2	0.3	0.3	0.3
Other utilities, social and personal services	0.9	0.9	1.0	0.9	1.0
Other types of economic activities	0.0	0.0	0.0	0.0	0.0
Loans not attributed to economic activities	42.9	38.4	40.9	41.2	41.2
Residential real estate loans to total (non-interbank) loans	27.8	29.1	33.2	34.0	34.8
Large exposures to regulatory capital [1, 5]	152.7	129.4	114.9	...	...
Earnings and profitability					
RoE [1, 2]	25.93	13.54	-48.4	-4.7	15.68
RoA [2]	1.71	1.01	-4.2	-0.3	1.26
Interest margin to gross income	55.8	62.2	50.4	49.5	58.6
Noninterest expenses to gross income	49.8	52.7	59.0	66.7	61.8
Trading and foreign exchange gains (losses) to gross income	8.1	3.2	14.1	8.1	3.9
Personnel expenses to noninterest expenses	43.6	42.4	39.8	36.8	41.1
Liquidity					
Liquidity ratio (liquid assets to current liabilities) [7]	43.5	39.0	49.9	42.8	40.3
Liquid assets to total assets [7]	21.9	18.6	23.7	24.1	23.2
Current liabilities to total liabilities [7]	54.2	51.4	50.5	60.8	62.8
3-month VILIBOR-EURIBOR spread, b.p.[8]	230	700	320	49	16
Spread between highest and lowest interbank rate, b.p. [10]	690	1650	970	436	0
Customer deposits to total non-interbank loans	66.4	53.5	66.9	77.9	78.7
Foreign exchange risk					
Foreign-currency-denominated loans to total (non-interbank) loans [11]	55.6	64.6	73.9	74.0	73.0
Foreign-currency-denominated liabilities to total liabilities [11]	56.2	63.3	61.6	57.0	57.6
Net open position in foreign exchange to regulatory capital [1, 9]	-2.43	0.39	0.8	0.4	1.40

Source: Bank of Lithuania.

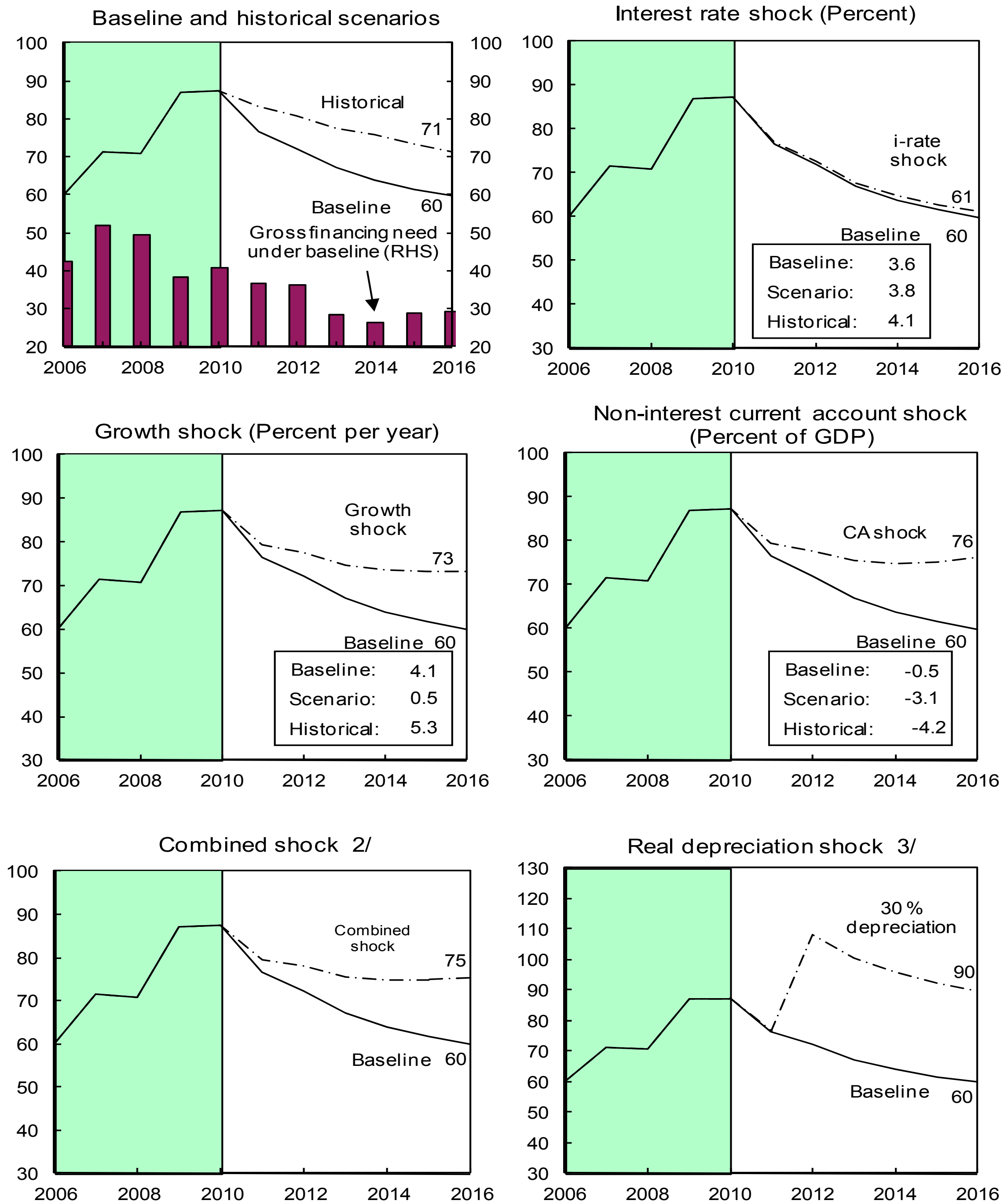
1/ Excluding foreign bank branches.
2/ Total profits (losses) after tax. Interim quarterly results are annualised.
3/ From end-2005 to Q1-2008, NPLs are loans overdue more than 60 days. Untill 2004 NPLs are loans in Substandard, Doubtful and Loss loans categories.
4/ Starting June 2008, non-performing loans are defined as the sum of impaired loans and non-impaired loans that are overdue more than 60 days.
5/ Large exposure means loans granted to the borrower the net value of which equals to, or exceeds, 10 per cent of bank capital.
6/ Credit registry data from 2005.
7/ Composition of liquid assets and current liabilities is defined in the Liquidity Ratio Calculation Rules approved by Resolution No. 1 of the Board of the Bank of Lithuania of 29 January 2004.
8/ Data as of the end of period.
9/ As defined in Rules for Calculation of Capital Adequacy approved by Bank of Lithuania Board Resolution No. 138 of 9 November 2006.
10/ Information is based on interbank deals of all maturities (mostly overnights) made between resident banks in national currency within the last quarter of the period.
11/ The large majority of foreign currency loans and foreign currency liabilities are in euros, to which the national currency is pegged via a currency board arrangement.
12/ Specific provisions include provisions against general portfolio risk until end-2004. From end-2005, due to the change in definition of NPLs, specific provisions are not directly attributable to the NPLs. Therefore, the ratio may be negative.
13/ From end-2005, due to the change in the definition of NPLs, specific provisions are not directly attributable to NPLs. Therefore, the ratio may be negative.
14/ Specific provisions include allowances for both individually and collectively assessed loans.

Annex 1. Lithuania: External Debt Sustainability Framework, 2006-2016
(Percent of GDP, unless otherwise indicated)

	Actual					Projections							
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016		**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	59.9	71.5	70.9	87.0	87.4	**76.6**	**72.1**	**67.0**	**63.9**	**61.6**	**59.8**		**-2.0**
Change in external debt	9.4	11.6	-0.6	16.1	0.4	-10.8	-4.5	-5.1	-3.1	-2.3	-1.8		
Identified external debt-creating flows (4+8+9)	-0.6	4.0	3.3	13.6	-1.3	-3.9	-1.5	-1.1	-0.6	0.4	0.9		
Current account deficit, excluding interest payments	9.0	12.0	9.6	-7.8	-4.2	-1.4	-0.4	0.4	1.0	1.6	2.0		
Deficit in balance of goods and services	10.3	13.3	11.7	1.3	1.1	1.3	1.4	1.5	1.7	2.0	2.2		
Exports	58.7	53.7	59.5	54.3	68.2	76.7	76.2	76.4	76.2	76.2	76.7		
Imports	68.9	67.0	71.2	55.6	69.2	78.0	77.5	78.0	77.9	78.2	78.9		
Net non-debt creating capital inflows (negative)	-4.7	-0.7	-1.4	2.5	1.4	-0.3	-0.8	-1.1	-1.4	-1.4	-1.5		
Automatic debt dynamics 1/	-5.0	-7.3	-4.9	18.9	1.5	-2.2	-0.3	-0.3	-0.2	0.2	0.4		
Contribution from nominal interest rate	1.6	2.4	3.3	3.3	2.7	2.7	2.2	2.2	2.1	2.5	2.7		
Contribution from real GDP growth	-3.4	-4.9	-1.8	12.8	-1.2	-4.9	-2.5	-2.5	-2.4	-2.3	-2.2		
Contribution from price and exchange rate changes 2/	-3.1	-4.7	-6.4	2.7	...	...	...	...	...	...	...		
Residual, incl. change in gross foreign assets (2-3) 3/	10.1	7.5	-3.9	2.6	1.7	-6.9	-3.1	-4.0	-2.5	-2.7	-2.7		
External debt-to-exports ratio (in percent)	102.1	133.1	119.1	160.3	128.3	100.0	94.7	87.7	83.9	80.8	78.0		
Gross external financing need (in billions of US dollars) 4/	10.3	15.0	16.1	10.2	11.2	11.3	12.0	10.0	10.0	11.6	12.7		
in percent of GDP	42.5	52.1	49.7	38.4	40.7	36.6	36.3	28.3	26.4	28.7	29.5		
Scenario with key variables at their historical averages 5/						**83.2**	**81.0**	**77.6**	**75.7**	**73.4**	**71.2**		**0.0**
Key Macroeconomic Assumptions Underlying Baseline												For debt stabilization	
Real GDP growth (in percent)	7.8	9.8	2.9	-14.8	1.4	6.3	3.5	3.7	3.8	3.8	3.8	3.8	
GDP deflator in US dollars (change in percent)	6.6	8.6	9.8	-3.7	2.0	5.7	3.4	3.2	3.0	2.7	2.6	2.6	
Nominal external interest rate (in percent)	3.7	4.8	5.2	3.8	3.2	3.5	3.1	3.2	3.4	4.1	4.6	4.6	
Growth of exports (US dollar terms, in percent)	17.9	9.2	25.1	-25.2	29.8	26.4	6.3	7.4	6.6	6.6	7.2		
Growth of imports (US dollar terms, in percent)	23.1	15.9	20.0	-36.0	28.9	26.6	6.4	7.6	6.8	7.1	7.4		
Current account balance, excluding interest payments	-9.0	-12.0	-9.6	7.8	4.2	1.4	0.4	-0.4	-1.0	-1.6	-2.0		
Net non-debt creating capital inflows	4.7	0.7	1.4	-2.5	-1.4	0.3	0.8	1.1	1.4	1.4	1.5		

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex 2. Lithuania: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



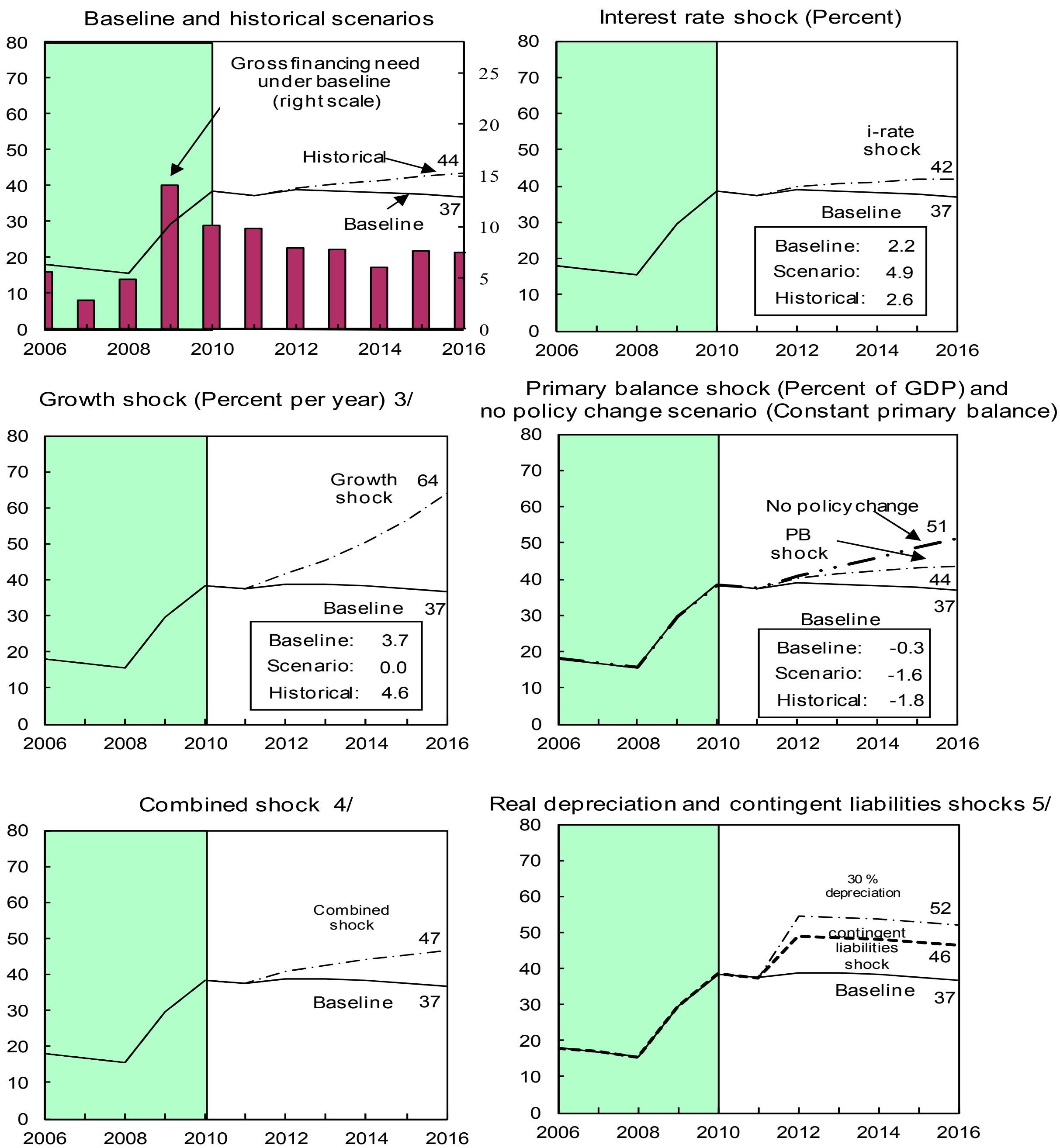
Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2011.

Annex 3. Lithuania: Public Sector Debt Sustainability Framework, 2006-2016
(Percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	17.9	16.8	15.5	29.4	38.0	**37.5**	**38.8**	**38.7**	**38.2**	**37.6**	**36.8**	**-0.2**
o/w foreign-currency denominated	14.5	14.0	12.8	27.0	34.2	32.2	32.6	31.8	30.6	30.1	29.4	
Change in public sector debt	-0.4	-1.1	-1.3	13.9	8.6	-0.5	1.3	-0.1	-0.5	-0.6	-0.8	
Identified debt-creating flows (4+7+12)	-3.3	-3.4	1.8	11.3	8.9	0.9	0.4	-0.1	-0.5	-0.6	-0.8	
Primary deficit	-0.3	0.3	2.6	7.9	5.2	3.2	1.1	0.6	0.1	-0.1	-0.3	
Revenue and grants	33.3	33.8	34.0	34.7	34.3	33.2	34.4	33.9	33.4	33.0	32.7	
Primary (noninterest) expenditure	33.0	34.1	36.6	42.6	39.5	36.4	35.5	34.5	33.6	32.9	32.4	
Automatic debt dynamics 2/	-2.8	-3.5	-0.7	4.1	3.7	-2.3	-0.7	-0.7	-0.6	-0.5	-0.5	
Contribution from interest rate/growth differential 3/	-1.7	-2.2	-1.3	4.7	0.9	-2.3	-0.7	-0.7	-0.6	-0.5	-0.5	
Of which contribution from real interest rate	-0.4	-0.7	-0.8	1.9	1.3	-0.1	0.6	0.7	0.7	0.8	0.9	
Of which contribution from real GDP growth	-1.2	-1.5	-0.4	2.8	-0.4	-2.1	-1.2	-1.3	-1.4	-1.4	-1.4	
Contribution from exchange rate depreciation 4/	-1.1	-1.3	0.5	-0.6	2.8	...	...	...	...	...	...	
Other identified debt-creating flows	-0.2	-0.2	-0.1	-0.8	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-0.2	-0.2	-0.1	-0.8	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	
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	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	2.9	2.3	-3.1	2.6	-0.3	-1.9	1.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	54.0	49.8	45.6	84.5	110.9	112.9	112.8	114.3	114.3	114.1	112.4	
Gross financing need 6/	5.6	2.8	4.9	14.1	10.1	9.8	7.9	7.8	6.1	7.6	7.5	
in billions of U.S. dollars	1.7	1.1	2.3	5.2	3.7	4.3	3.7	3.8	3.2	4.2	4.4	
Scenario with key variables at their historical averages 7/						**37.5**	**39.5**	**40.6**	**41.6**	**42.7**	**43.7**	**-0.6**
Scenario with no policy change (constant primary balance) in 2011-2016						**37.5**	**40.9**	**43.4**	**45.9**	**48.5**	**51.1**	**-0.3**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	7.8	9.8	2.9	-14.8	1.4	6.3	3.5	3.7	3.8	3.8	3.8	
Average nominal interest rate on public debt (in percent) 8/	4.6	4.7	4.5	6.9	6.6	5.7	5.1	5.2	5.2	5.2	5.2	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-2.0	-3.9	-5.2	10.6	4.6	0.0	1.7	2.0	2.1	2.5	2.6	
Nominal appreciation (increase in US dollar value of local currency, in percent)	10.6	11.6	-3.8	3.6	-9.5	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	6.6	8.6	9.8	-3.7	2.0	5.7	3.4	3.2	3.0	2.7	2.6	
Growth of real primary spending (deflated by GDP deflator, in percent)	8.8	13.6	10.5	-0.8	-6.1	-2.1	1.0	0.8	1.0	1.6	2.3	
Primary deficit	-0.3	0.3	2.6	7.9	5.2	3.2	1.1	0.6	0.1	-0.1	-0.3	

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 - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = 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 - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Annex 4. Lithuania: Public Debt Sustainability: Bound Tests 1/ 2/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ The growth shock should be seen as extreme, as it is modeled in part on the 2008-10 GDP collapse.
4/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
5/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND

THE REPUBLIC OF LITHUANIA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 1, 2011

Prepared By	European Department

CONTENTS

FUND RELATIONS

(As of September 30, 2011)

Membership Status

Joined: April 29, 1992; Article VIII

General Resources Account

	SDR Million	Percent Quota
Quota	183.90	100.00
Fund holdings of currency	183.88	99.99
Reserve position in Fund	0.03	0.02

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	137.24	100.00
Holdings	137.31	100.05

Outstanding Purchases and Loans

None

Latest Financial Arrangements

In millions of SDR, (mm/dd/yyyy)

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
Stand-by	08/30/2001	03/29/2003	86.52	0.00
Stand-By	03/8/2000	06/7/2001	61.80	0.00
EFF	10/24/1994	10/23/1997	134.55	134.55

Projected Payments to Fund

None

Implementation of HIPC Initiative:

Not applicable

Implementation of MDRI Assistance:

Not applicable

Current Status of Safeguards Assessments:

Under the Fund's safeguards assessment policy, the Bank of Lithuania (BOL) was subject to and completed a safeguards assessment with respect to the Stand-By Arrangement, (the SBA was approved on August 30, 2001 and expired on March 29, 2003) on December 10, 2001. The assessment identified certain weaknesses and proposed appropriate recommendations as reported in EBS/01/211. The BOL has implemented these recommendations.

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 joined the European Union (EU) on May 1, 2004, and ERM II on June 28, 2004. Lithuania has accepted the obligations of Article VIII of the Fund’s Articles of Agreement and maintains an exchange system free of restrictions on the making of payment and transfers for current international transactions except for those maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

Article IV Consultation:

Lithuania is on the 12-month consultation cycle. The last Article IV consultation was concluded on July 08, 2010. The Executive Board assessment is available at http://www.imf.org/external/np/sec/pn/2010/pn1080.htm and the staff report and other mission documents at http://www.imf.org/external/pubs/cat/longres.aspx?sk=24026.0

FSAP Participation and ROSCs:

An FSAP Update mission was completed on November 19, 2007. Fiscal and statistics ROSCs were completed in November 2002 and December 2002, respectively.

Technical Assistance:

The table on the following page summarizes the technical assistance missions provided by the Fund to Lithuania since 1999.

Resident Representative: Mark Allen (stationed in Warsaw, Poland).

Anti-money laundering and combating financing of terrorism:

Lithuania's compliance with the international AML/CFT standard, the Financial Action Task Force's (FATF) 40+9 Recommendations, was assessed by MONEYVAL, the FATF-style regional body of which it is a member, in January 2006. The ensuing AML/CFT assessment report was adopted by the MONEYVAL Plenary in November of that same year. Since then it has produced two progress reports, the first of which was adopted in March 2008 and the most recent report was adopted in March 2010. At the occasion of Lithuania's latest progress report the significant steps taken by Lithuania over the past years were acknowledged. At the same time the country indicated that it was still working on amending its Criminal Code to unify its money laundering definitions, to bring this definition in line with the Vienna and Palermo Conventions and to ensure dissuasive criminal sanctions against money laundering. According to the authorities, since the assessment report was adopted better customer due diligence (CDD) measures were introduced, including regarding the identification of shareholders of legal persons, and improvements were made regarding the obligation to transmit suspicious transaction reports (STRs). They also stated progress was made in the areas of implementation of UN instruments and the freezing and confiscation of terrorist assets.

LITHUANIA: TECHNICAL ASSISTANCE FROM THE FUND, 1999–2011

Department	Issue	Action	Date	Counterpart
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, 2001	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
FAD	Treasury Operations	Mr. Ramachandran	Nov 22-Dec 5 2004	Ministry of Finance
FAD	Decentralization	Mission	Dec 3-Dec 15 2004	Ministry of Finance
STA	External debt statistics	Mission	Aug 2-4, 2006	Bank of Lithuania
MCM	Stress testing	Mr. Miguel A. Segoviano Basurto	June 11-21, 2007	Bank of Lithuania
STA	External debt statistics	Mission	November 8-19, 2007	Bank of Lithuania
FAD	Public expenditure review	WB mission / Ms. Budina (FAD) participation	April 14-24, 2009	Ministry of Finance
FAD	Tax Administration	Mission	Aug 26–Sept. 8, 2009	Ministry of Finance
MCM/LEG	Bank Resolution/Banking Law	Mission	Sept. 28–Oct. 6, 2009	Bank of Lithuania/Ministry of Finance
FAD	Reform of Social Security and Health Funds	Mission	April 6-20, 2010	Ministry of Finance/State Social Insurance Fund Board
LEG	Personal Bankruptcy Reform	Mission	April 30–May8, 2010	Ministry of Economy
FAD	Tax Administration	Mission	July 14-27, 2010	Ministry of Finance
FAD	General Tax Policy	Mission	October 19-25, 2010	Ministry of Finance

STATISTICAL ISSUES

Over the past several years, Lithuania has made good progress in establishing a macroeconomic database. Official data for all sectors are adequate for surveillance purposes.

Lithuania subscribed to the Special Data Dissemination Standard (SDDS) in May 1996, and its metadata have been posted on the Fund's Dissemination Standards Bulletin Board (DSBB) since April 1997. Lithuania meets the SDDS specifications for coverage, periodicity and timeliness of the data, and for the dissemination of the advance release calendars. A significant amount of economic and financial information is now available on various websites through the Internet (see section on Dissemination of Statistics, below). A ROSC data module was published in November 2002.

National Accounts

The national accounts are compiled by Statistics Lithuania (SL) (the former Department of Statistics) 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 using both 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 separately in the published figures as the discrepancies are included in the estimates of changes in inventories. The annual and the quarterly national accounts are compiled at previous year prices and chain-linked to 2000. In general, good data sources and sound methods are used for the compilation of the national accounts, but measuring activity in the current volatile environment is proving very challenging. Moreover, difficulties remain in measuring the economic activity of the informal sector. These estimates are compiled at detailed levels of economic activity using fixed coefficients derived from a benchmark surveys conducted in 1996 and 2003, and updated in 2006. According to the most recent updates, the informal sector was estimated to be 13 percent of GDP in 2008. A new benchmark survey will be released at the end of 2011.

Price Data

Since December 1998, CPI weights have been updated annually. 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

Data on the central government budget execution are available at a monthly and quarterly frequency, although these data are subject to frequent revisions. The ongoing treasury project is expected to improve fiscal data quality substantially. However, further work is needed to clarify the treatment of public health care providers and of EU transactions, and the consolidation procedure for government operations. A new classification, incorporating the GFSM2001 was approved in mid-2003. Since then, the MoF has been reporting to STA general government's annual data on an accrual and cash basis (except for local governments, which are still on a cash basis) for publication in the Government Finance Statistics Yearbook (GFSY). In addition, the MoF has been reporting quarterly and monthly data in the GFSM 2001 format for publication in the IFS.

Monetary and Financial Statistics

The Bank of Lithuania (BoL) reports monetary and financial statistics (MFS) to STA on a timely and regular basis. The scope, concepts and definitions of the MFS are broadly in line with the guidelines of the Monetary and Financial Statistics Manual (MFSM). Following Lithuania's accession to the European Union, the BoL implemented the ECB framework for compiling and reporting monetary data reflecting the ECB regulations and ESA 95 on sectorization, valuation and classification of financial instruments.

External Sector

The BoL is responsible for compiling balance of payments, international investment position (IIP), external debt and international reserves statistics. The BoL reports quarterly data on balance of payments, IIP and monthly international reserves to STA on a timely and regular basis. Balance of payments data (on a monthly and quarterly basis) are compiled using the format recommended in the Balance of Payments Manual, fifth edition (BPM5). 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 monthly according to the operational guidelines and is hyperlinked to the Fund's DSBB. Since late 2004, the BoL disseminates quarterly external debt data in the World Bank's Quarterly External Debt Statistics (QEDS) database.

Dissemination of Statistics

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

- 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/eng/statistic/index.html) provides data on monetary statistics, treasury bill auction results, balance of payments, IIP, external debt and other main economic indicators;
- the SL website (http://www.stat.gov.lt) provides monthly and quarterly information on economic and social development indicators;
- the MoF (http://www.finmin.lt) home page includes data on the national budget, as well as information on laws and privatization; and government finance statistics (deficit, debt).
- NASDAQ OMX Baltic website (http://www.lt.omxgroupnasdaqomxbaltic.com./?lang=en) has includes information on stock trading at NASDAQ OMX Baltic stock Exchange in Vilnius (the former Vilnius Stock Exchange).

LITHUANIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE—AS OF OCTOBER 31, 2011

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	October 31, 2011	October 31, 2011	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	August 2011	October 13, 2011	M	M	M		
Reserve/Base Money	September 2011	October 14, 2011	M	M	M	O, LO, LO, LO	O, O, LO, O, O
Broad Money	September 2011	October 14, 2011	M	M	M		
Central Bank Balance Sheet	September 2011	October 14, 2011	M	M	M		
Consolidated Balance Sheet of the Banking System	September 2011	October 14, 2011	M	M	M		
Interest Rates[2]	September 2011	October 10, 2011	M	M	M		
Consumer Price Index	September 2011	October 11, 2011	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q2/2011	October 20, 2011	Q	Q	Q	LO,LO,LO,O	O,O,O,O,O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	August 2011	October 28, 2011	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	August 2011	October 28, 2011	M	M	M		
External Current Account Balance	Q2/2011	September 20 2011	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	August 2011	October 13, 2011	M	M	M		
GDP/GNP	Q2/2011	October 3, 2011	Q	Q	Q	O, LO, O, LO	O, LO, LO, LO, O
Gross External Debt	Q2/2011	September 20, 2011	Q	Q	Q		
International Investment Position	Q2/2011	September 20,2011	Q	Q	Q		

[1] Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

[8] Reflects the assessment provided in the data ROSC (published on November 22, 2002, and based on the findings of the respective missions that took place during May 8-22, 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[9] Reflects the assessment provided in the data ROSC (published on November 22, 2002, and based on the findings of the respective missions that took place during May 8-22, 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO)

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IMF Executive Board Concludes 2011 Article IV Consultation with the Republic of Lithuania

On November 16, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Lithuania.[1]

Background

The economy has staged an impressive recovery, based on a supportive global environment and determined policy adjustment. After contracting sharply in 2008-09, economic activity grew by 1½ percent in 2010 and a robust 6¼ percent in the first half of 2011. The main driver of the recovery was export growth, underpinned by strong external demand and sharp nominal wage declines that restored competitiveness. There are early signs of a reallocation of resources towards tradable sectors, such as rapid growth of employment in the transport sector and an increase in the share of foreign direct investment going to manufacturing.

The export-led recovery has over the past year broadened to domestic demand, lowered unemployment, and stabilized wages. With higher domestic demand stimulating imports, the current account has moved from a slight surplus in 2010 to a small deficit in 2011. External

[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

debt has fallen since 2009 as foreign-owned banks have reduced liabilities to their parents, but is still relatively high. Higher energy and food prices pushed up inflation in early 2011, but inflation has slowed recently in line with international commodity price trends.

The fiscal deficit narrowed from 9.2 percent of GDP in 2009 to 7.1 percent of GDP in 2010, and has continued to contract thus far in 2011. Fiscal consolidation reflected mostly reductions in wages and social benefit payments. The government has fully financed its needs in 2011, but has some 8 percent of GDP in gross financing needs in 2012.

The banking system as a whole is on the mend, but pockets of weakness remain. Nonperforming loans have stabilized, net interest margins have risen, the average capital adequacy ratio is above the pre-crisis level, and liquidity has increased. However, a few banks have set aside lower provisions for losses than others despite having higher nonperforming loan ratios.

Executive Board Assessment

Executive Directors commended the authorities for Lithuania's impressive economic recovery, noting in particular the sizeable fiscal consolidation, the maintenance of confidence in the banking system, and the significant wage adjustment that underpinned gains in competitiveness. The export-led recovery has broadened to domestic demand and reduced unemployment. Given heightened uncertainty in the external environment, Directors underlined the importance of continued vigilance and sustained progress in strengthening fiscal, financial, and structural policies.

Directors supported the authorities' goal of further reducing the fiscal deficit, thereby putting government debt on a downward path. They considered it desirable to rely on sustainable measures, including the expansion of wealth taxation and broadening tax bases, while protecting spending on public investment and the most vulnerable people from further cuts. Directors saw merit in preparing a contingency plan in the event that downside risks to growth materialize. Over the medium term, Directors recommended further strengthening tax compliance, the fiscal framework, the pension and health care systems, and the governance of state-owned enterprises.

Directors observed that the banking system as a whole is liquid and well capitalized. Addressing remaining pockets of weakness is a priority, including through conservative risk assessments, appropriate loan loss provisions, and further capital increases where necessary. Directors also emphasized the need for a broader range of bank resolution tools and more effective personal and corporate insolvency regimes, along the lines of European and global initiatives. They looked forward to progress in unifying financial supervision under the central bank.

Directors underscored that enhancing labor participation and facilitating labor reallocation to tradable sectors are key to sustainable growth. They supported the authorities' intention to expand the use of fixed-term contracts and make full use of EU structural funds to overcome skill mismatches. Directors called for a cautious approach to increasing the minimum wage, consistent with productivity developments. Further efforts to improve the business environment are also crucial.

Republic of Lithuania: Selected Economic Indicators

	2008	2009	2010	2011 Projections
Real Economy				
Real GDP growth	2.9	-14.8	1.4	6.3
CPI inflation, end of period	8.5	1.2	3.8	3.8
Unemployment rate (year average, in percent of labor force)	5.8	13.7	17.8	15.5
Public Finance	(In percent of GDP)			
General government balance	-3.3	-9.5	-7.1	-5.1
General government gross debt	15.5	29.4	38.0	37.5
Foreign currency-denominated public debt	12.8	27.0	34.6	32.2
Balance of Payments	(In percent of GDP, unless otherwise specified)			
Current account balance	-12.9	4.4	1.5	-1.3
Gross official reserves (in billions of euros)	4.6	4.6	5.2	5.6
Exchange Rates	(Litai per U.S. dollar, unless otherwise specified)			
Exchange rate (end of period)	2.45	2.40	2.61	…
Exchange rate (period average)	2.36	2.48	2.61	…
Real effective exchange rate (2005=100, increase=appreciation)	110.9	118.4	113.2	…
Money and Credit	(Year-on-year percent change)			
Reserve money	-1.4	-17.2	19.4	2.7
Broad money	-0.4	0.3	8.9	8.9
Private sector credit	17.8	-6.9	-7.6	-1.7

Sources: Lithuanian authorities; and IMF staff estimates.

Statement by Mr. Benny Andersen, Executive Director for the Republic of Lithuania and Mr. Rimtautas Bartkus, Advisor to the Executive Director
November 16, 2011

The Lithuanian authorities highly appreciate the Fund's economic policy advice and thank Mr. Morsink and his team for productive discussions and valuable policy insights provided during the 2011 Article IV consultations in Vilnius. The authorities broadly agree with staff's analysis and policy recommendations. The recent years have been exceptional for economic policy making in Lithuania. The authorities had to steer the economy to a safe landing after the domestic demand boom burst and when the worsening external outlook provided additional tailwinds. Supported by determined policy actions and inner flexibility of the economy, macroeconomic imbalances have been quickly reversed and the economy staged a quick recovery as the external demand strengthened. During one of the largest economic adjustments in the country's history, the society demonstrated unique perseverance and political stability has been maintained. The economic adjustment in Lithuania is becoming more structural as the political capital is being increasingly allocated on deepening the structural reforms that should pave the way for a more sustainable growth model, enhance fiscal transparency and soundness, as well as financial resilience. Policies pursued by the Lithuanian authorities are fully aligned with the euro area membership objective.

Economic outlook and risks

The macroeconomic scenario foreseen by the authorities is in line with staff's projections. The recently announced data confirm that robust economic expansion continued in the third quarter of 2011 with real GDP increasing by 6.6 percent year-on-year. Large internal adjustment and deleveraging that occurred in 2008-09 improved Lithuania's economic competitiveness and allowed Lithuania to benefit strongly from the more favorable external conditions. The signs of economic reorientation have occurred with the tradable sector playing a more prominent role in the recovery. Significant improvement in unit labor costs supported export performance and allowed to gain export market shares. The export volume reached its pre-crisis highs already in October 2010 and strong positive developments in the export sector continued in the course of 2011 before moderating lately, in line with the changing economic sentiment in Lithuania's key export markets.

The export-led recovery that started in 2010 broadened to domestic demand in 2011 and has eventually become a twin-engine growth. Demand for investment has returned with improving corporate profitability and higher capacity utilization, whereas increasing employment strengthened consumer confidence. The strong surplus in the services balance and increasing current transfers had a positive effect on the current account, but the current account recorded a small deficit as the demand for imported investment goods picked up markedly. Going forward, the modest current account deficit will be fully financed by the capital transfers from the EU. The net FDI flows should also increase as the authorities' efforts to improve Lithuania's investment environment should yield higher dividends.

While the annual HICP inflation remains at an elevated level, it started to come down lately following the decline in the global food and energy prices. The core inflation returned to a positive territory after prolonged deflation, but it remains contained.

The situation in the labor market has started to improve gradually, although the unemployment rate is projected to stay above its historical average. Observed positive developments in employment were broad-based and not limited to a narrow set of economic activities. The employment dynamics have been favorably affected by the improved economic outlook. The amendments to the labor code that provided better opportunities for temporary and part-time hiring also contributed to the labor demand as it allowed the companies to adjust more smoothly to the fluctuating demand for new orders.

Overall, the economy is now in a much healthier condition to withstand potential shocks, though trade and financial integration constitutes higher spillovers risks for Lithuania. Acknowledging this risk, the projected economic growth of 4.7 percent in 2012 could be revised by approximately 1 percentage point downwards.

Fiscal policy and structural reforms

The authorities' fiscal strategy is geared towards restoring public finance sustainability, putting debt on a downward trajectory, and preserving market confidence in the consolidation efforts. The track record of implementation certifies that the consolidation path is firmly established. The fiscal outturn for 2010 was 1 percentage point better than initially projected due to stronger revenue growth and maintained strict expenditure control. Taking into account improved economic outlook, the authorities revised the 2011 fiscal deficit target to 5.3 percent of GDP and are well on track to secure the final outcome for the general government deficit even below 5 percent of GDP. The consolidation measures in 2011 included further extension of expenditure cuts on public sector wages and pensions, reduction of generous parental benefits, and better targeting social support. The reduced transfers to the private pension funds (Pillar 2) are maintained until the further reform of the pension system and its privately funded part has been implemented.

The draft 2012 budget is set to achieve the 2.8 percent of GDP fiscal deficit target. The general government debt is projected to slightly decrease in 2012 to 37.3 percent of GDP and the financing needs will be met by borrowing in domestic and international markets. The recent USD 750 million bonds (a tap of the existing USD 750 million bond due in 2021) issued in international capital markets serves as a pre-funding exercise for the next year and confirms Lithuania's access to international capital markets at a reasonable price even during volatile markets. Under the 2012 draft budget, the public sector wage freeze will be maintained; appropriations for the ministries will be cut by additional 2 percent; and the reduced social assistance and unemployment benefits will become permanent. The primary expenditure excluding the co-financing for the EU supported investment projects will be 1.8 percent lower compared to 2011. Taking into account social vulnerability of the retired persons, the crisis related cut in pensions will not be extended, though the pensions will remain below their pre-crisis level in real terms due to absence of indexation. To ensure that the 2.8 percent fiscal deficit target is met, the budget law will establish an interim expenditure ceiling and introduce the requirement for a supplementary budget if it becomes clear that the revenue plan is unlikely to be met by the margin of 3 percent.

The authorities' fiscal consolidation efforts are focused on the fruits that have matured and on the completion of the structural reforms that have already been started. No significant tax changes are foreseen for 2012 so far. Building on the success of the tax compliance strategy that has been developed with the technical support from the Fund, the authorities plan further measures to increase tax compliance. In addition to the numerical expenditure rule that is currently in place, the authorities consider further ways to strengthen the fiscal framework. To reduce possible fiscal risks due to liabilities incurred at the municipality level, the authorities are also revising the framework for municipalities' financing. The authorities see potential for increasing wealth taxation, but it requires broad consensus and the exact modalities need to be worked out. The government already proposed to change the valuation method for the land tax, which would be based on the market value.

The structural expenditure reforms in social security, health care, and education sectors are advancing. The final decision to increase the retirement age was taken in June and the retirement age will be gradually increased from 2012. The Parliament also approved the comprehensive pension reform guidelines that aim to strengthen the link between pension benefits, demographic factors, and contributions. The authorities aim to complete the reform of the pension system in 2012. The reform of the health care and education sector is approaching a stage where the number of institutions providing health care and education services will start to be consolidated. The authorities also expect to reinvigorate the housing renovation program that will provide further impetus for employment and will yield significant savings on the imported energy bill, improving the current account balance over the medium-term.

The authorities underscore the significant transparency and efficiency gains they expect from reforming the management of state owned enterprises (SOEs). The reform aims to enhance efficiency of SOEs by setting higher requirements for financial reporting and accountability, revising management structure, introducing more stringent cost-benefit analysis, and separating SOEs commercial and non-commercial functions. The reform efforts should yield considerably higher revenue. Based on the analysis of the available data on the SOEs financial performance, also taking into account the proposed new rules for the SOEs profit sharing, the draft 2012 budget includes 0.4 percent of GDP in additional revenue from SOEs.

Financial stability and financial sector policies

As the macroeconomic outlook has improved, the banks operating in Lithuania were able to achieve higher net interest margins, the level of NPLs started to come down, and the profitability of the banking system has increased. The Lithuanian banks rely on stable sources of funding and hold sizeable liquidity buffers to withstand potential shocks. The liquidity ratio made up 41.7 percent for 2011 Q3 and significantly exceeded the 30 percent minimum established by the Bank of Lithuania. The share of retail deposits to total liabilities has increased to 60.1 percent in September 2011 and the parent bank funding has decreased to 30.6 percent of the total liabilities. The rigorous stress tests performed by the Bank of Lithuania showed that even under the adverse scenario the banking system's liquidity ratio would remain close to the regulatory requirement. The capital adequacy ratio of the banking system stood at 14.1 percent as of 2011 Q3, and substantially exceeded the regulatory capital requirement of 8 percent. The banking system's Tier 1 capital ratio increased from 10.9 to 11.2 percent over the year. However, some banks still need to increase loan loss provisioning and strengthen the capital base. The banks operating in Lithuania have only limited direct exposure to the sovereign debt of the Southern European countries with the spillovers that effect demand for export and the conditions for sovereign financing considered being a more important risk.

In 2011 the authorities advanced a number of important initiatives that will allow for further strengthening of the systemic resilience in the financial sector:

1) Seeking to achieve economies of scope in supervising Lithuania's bank-based financial system and to ensure better coordination and systemic risk management, the authorities decided to consolidate the financial sector supervision under the Bank of Lithuania. The reform foresees transferring the insurance and securities sector supervision function to the central bank that will also assume responsibility to provide consumer financial protection services. The reformed supervisory authority will report to the designated member of the board of the Bank of Lithuania. The financial supervision function will be financed from market participants' contributions and the central bank's resources. The reform will enhance the institutional, political, operational, and financial independence in carrying out the financial sector supervision. The necessary legal amendments have been presented to the Parliament and should be passed into law by December 2011. The operational preparedness to implement the foreseen reforms from the beginning of 2012 is well advanced too.

2) The prudential framework has been strengthened by adopting the Regulations for Responsible Lending that established clear limits on loan-to-value, loan-to-income, loan maturity, and strengthened the requirements for banks to inform customers about the borrowing risks.

3) Further progress has been made on operational preparedness for cross-border crisis management. The Lithuanian authorities signed the Nordic-Baltic cooperation agreement on cross-border financial stability, crisis management, and resolution and participate in the Nordic-Baltic Cross-Border Stability Group, which was established to implement the provisions of the agreement. The Lithuanian authorities continued participation in the supervisory colleges established to supervise the cross-border banking groups.

4) With the help of the Fund's technical assistance the authorities prepared the law on natural persons' bankruptcy that should be adopted by December 2011. The law will enhance the insolvency regime by providing opportunities for orderly natural persons' debt restructuring.