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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/127

10:00 a.m., October 21, 1992

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	L. E. N. Fernando
	T. P. Thomas, Temporary
	Duan J., Temporary
	G. C. Noonan
T. C. Dawson	
	J. Prader
	R. L. Knight
R. Filosa	
	M. A. Ahmed, Temporary
I. Fridriksson	J. A. Solheim
	S. Shimizu, Temporary
	B. Esdar
	T. Sirivedhin
	P. Rubianes, Temporary
J.-P. Landau	P. Bonzom, Temporary
	M. J. Mojarrad, Temporary
	L. J. Mwananshiku
	J. Dorrington
G. A. Posthumus	
C. V. Santos	
	A. Martínez-Alas, Temporary
A. Végh	

L. Van Houtven, Secretary and Counsellor
T. S. Walter, Assistant

Also Present
IBRD: U. Zachau, Europe and Central Asia Regional Office. Central Asia Department: B. B. Aghevli, Deputy Director. European Department II: J. Odling-Smee, Director; E. Brau, Deputy Director; E. Hernández-Catá, Deputy Director; A. Knobl, V. R. Koen, M. Marrese, T. O. Saavalainen, T. Shikado, G. H. R. Tersman, J. R. Wein, B. B. Zavoico. External Relations Department: M. R. Kelly, Deputy Director; P. M. Falcone. Fiscal Affairs Department: V. C. Thai. Legal Department: F. P. Gianviti, General Counsel; P. De Boeck, J. L. Hagan, Jr. Monetary and Exchange Affairs Department: A. Kovanen, B. K. Short. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; D. Burton, P. K. Cornelius. Research Department: P. Isard, M. D. Knight, D. Villanueva. Secretary's Department: J. W. Lang, Deputy Secretary; R. S. Franklin, A. Jbili. Treasurer's Department: D. Williams, Treasurer; D. Gupta, A. F. Moustapha, P. M. Tillotson. Office of the Managing Director: R. Saunders, Personal Assistant. Advisors to Executive Directors: J. M. Abbott, B. R. Fuleihan, A. R. Ismael, W. Laux, A. Törnqvist. Assistants to Executive Directors: S. Al-Huseini, J. H. Brits, M. E. Hansen, P. K. Kafle, K. J. Langdon, G. J. Matthews, F. Moss, L. F. Ochoa, R. K. W. Powell, S. Vori.

1. REPORT BY MANAGING DIRECTOR

At Informal Session/92/5 (10/19/92), the Managing Director made the following report:

I would like to inform Executive Directors about my recent visit to Kazakhstan, Kyrgyzstan, Austria, Albania, and Greece. I first visited Kazakhstan and Kyrgyzstan. In some ways, these two countries are very similar. Both economies are highly dependent upon the production and export of natural resources and mineral wealth, as well as upon agriculture. Both received significant transfers from the Union before they became independent. They are still closely tied to the Russian Federation in terms of trading and financial links, as well as security matters, and they have pushed hard for the creation and maintenance of a common economic space among the republics of the Commonwealth of Independent States (CIS). Both countries' populations have a wide-ranging ethnic mix, including a large minority of Slavs, and their Governments are strongly committed to maintaining social and ethnic stability.

The Governments in both countries moved relatively rapidly--compared with most other republics of the former Soviet Union--to begin the process of economic reforms late in 1991, and they are publicly committed to the transformation of their economies into market-based systems. At the same time, it is apparent that this process will be difficult, as not everybody in the Governments of these countries has shaken off the old ideas of the past command economy, and the institutional structures are weak. For example, I have doubts about how well the authorities understand the memorandums of economic policies that the staff is discussing with them, especially the underlying connections between the different components. It will take time and much careful explanation by the staff for a full understanding to be achieved.

Both countries followed relatively tight economic policies in the first half of this year, with balanced budgets, but severe pressures on expenditures are now manifesting themselves, and the authorities will need to display considerable courage as they prepare the 1993 budgets. I was particularly struck, in both Kazakhstan and Kyrgyzstan, by the authorities' deep concern about prospects for the stabilization of the ruble and their fears of hyperinflation. In general, I found the determination and realism of the political leadership quite refreshing. Finally, in both countries, there is great interest in Fund technical assistance and Fund-supported programs, and the authorities seem to have high expectations in these areas.

Despite these common points, there are important differences between the two countries. Kazakhstan is a large country with enormous natural resources, significant surpluses in food output, and broadly balanced trade in petroleum and other energy products; the terms of trade loss from the rise in oil prices has been minor. Kyrgyzstan, on the other hand, is a relatively small, mountainous country, which has suffered a very large terms of trade loss this year of up to 20-25 percent of GDP on account of the increase in oil prices, with more to come in the future; it is also a sizable net importer of food products.

In the short run, both countries face a difficult macroeconomic situation; however, while the medium-term outlook for Kazakhstan appears reasonably good--in part owing to substantial foreign investment agreements in the oil and gas sector, as well as promising prospects for exports in convertible currencies--Kyrgyzstan is likely to have significant pressures on its balance of payments for several years. Kazakhstan's relations with the Russian Federation are influenced by the issue of its nuclear forces and the need for common expenditures for the Baikonur space center; accordingly, the Kazakh Government has decided to form its own military forces. In Kyrgyzstan, however, the Government is determined not to create its own armed forces and will have only internal security, such as police and border guards.

An important issue that arose in the discussions was the authorities' concerns regarding developments in the ruble area and, in particular, the likely outcome of the then forthcoming CIS heads of state meeting in Bishkek on October 9-10, 1992--a subject to which I shall return. President Nazarbayev of Kazakhstan had made a specific proposal to other heads of state to strengthen the ruble area coordination of monetary and credit policies through the creation of an interstate bank. However, it was apparent that, unless common ground was found in Bishkek on closer coordination of decision making--which, for the Kazakhs, would require acceptance of a "one country, one vote" formulation--several states could move rapidly in the direction of separate currencies. Different concerns were expressed about the current system: the Kazakhs emphasized the lack of sovereignty; and the Kyrgyz, its apparent inability to prevent hyperinflation.

In my conversations in both countries, I stressed the critical importance of maintaining close economic and financial links among the various republics, regardless of decisions on monetary independence. This meant maintaining a common space and avoiding customs barriers, as well as urgently reinforcing the payments and settlement system, which is in a precarious state. I also made it clear that workable monetary arrangements would need to be in place, whether a country stayed in the ruble area or introduced a separate currency, before the Executive Board would be prepared to approve a program.

In discussions with heads of enterprises and the authorities in Kazakhstan and Kyrgyzstan, it was made clear that the payments and settlement system is not working well at all--it can take three to six months for enterprises to get paid, both within the country as well as at the interstate level--and output and trade are becoming adversely affected by this system. Clearly, action in this area will be needed, whether countries stay in the ruble area or move toward separate currencies. In this regard, I urged both Presidents to give the matter the highest priority in their discussions with other states of the former Soviet Union, and I promised that we will redouble our efforts to help.

In Kazakhstan, I had several meetings with President Nazarbayev. I also met with the Prime Minister, the Minister of Finance, the Chairman and management of the central bank, the Deputy Chairman of the Supreme Soviet, heads of key parliamentary committees, heads of certain state and private enterprises, and the diplomatic corps. The main purpose of my visit was to lend support to the preparation of the reform program that is under way. The President indicated that he intended to announce a comprehensive package of policy actions by November 15, 1992. He is keen to move ahead rapidly with the mass privatization of state assets, in part as a means of gaining popular support for the stabilization effort. My discussions with representatives from enterprises suggested that there is a clear desire on the part of managers for excessive regulations to be eliminated and settlement problems to be solved.

The President and I also agreed that, despite considerable uncertainties with regard to key elements, such as inflation and the exchange rate, tight budgetary policies would be needed for 1993, with the aim of avoiding any recourse to domestic bank financing. Consumer subsidies have already been cut back to include only a very limited number of key goods, such as medicines. It was agreed that a staff mission will visit Alma Ata in about ten days to continue negotiations on the memorandum of economic and financial policies, and on the letter of intent. Although a follow-up mission will probably be required to finalize the program, if very good progress is made, Kazakhstan's request for a stand-by arrangement could be presented to the Board sometime in January 1993.

In Kyrgyzstan, I had meetings with President Akaev, and with the Minister of Economy and Finance, the Chairman of the National Bank, the Minister of Foreign Economic Relations, key representatives of Parliament, heads of certain state and private enterprises, and provincial leaders.

The macroeconomic situation facing Kyrgyzstan is extremely difficult. My overall impression was that the Government takes the policy advice of the Fund very seriously: several aspects of the program under discussion are already being implemented, including the acceleration of the privatization effort and the reductions in subsidies. The Government's top priority now is to prevent further declines in production--output is estimated to fall by 20-25 percent this year--and speed up structural reforms. As in Kazakhstan, the authorities expressed concern about developments in the ruble area, including settlement problems.

In view of the sizable transfers that Kyrgyzstan received from the former Union and the severe terms of trade shock, a very large decline in the real incomes of the population is inevitable. The President and some others in Government recognize this, but it remains to be seen whether they will be able successfully to resist demands from the population for budgetary support. I stressed the need for a carefully targeted social safety net and noted that the international community would provide support for a strong, credible reform program. A staff team is leaving for Bishkek this week to continue negotiations on a program; as in the case of Kazakhstan, a follow-up mission will be required to finalize negotiations. If all goes well, a request for a stand-by arrangement could be brought to the Board early next year.

The preliminary balance of payments outlook for 1993--which still needs to be firmed up--indicates financing gaps that will need to be covered for both countries, even after taking into account the use of Fund resources, World Bank assistance, and debt deferral. As you know, in close collaboration with the World Bank, we have asked for consultative group meetings on Kazakhstan and Kyrgyzstan in mid-December 1992, with a view to seeking the necessary financing assurances from donors and creditors. Of course, prior to those meetings, the staff will communicate with Executive Directors to brief them on the programs and the financing needs. I believe that, if strong programs are agreed with these two countries, the financial community should do its utmost to support them with rapid assistance. This would set a good example for other countries in the region that may be inclined to be tardy in their reform efforts.

Now, I would like to update you on the CIS heads of state meeting in Bishkek on October 9-10, 1992. The meeting covered a wide agenda, including security as well as economic issues. The main outcome on the monetary side was an agreement to set up an interstate bank to manage ruble area arrangements; it appears that it will be more of a clearing union than a central bank. Although the Bishkek agreement also gives responsibility for setting credit limits in the short term to the central banks of the ruble area, acting collectively, it does not specify how decisions will be made. Recent experience invites skepticism about whether the arrangements for setting credit limits will ever work.

Thus, the Bishkek meeting has not clarified the way forward on monetary policy in the ruble area, and it may possibly have speeded up the decision to introduce national currencies in a number of countries. On the bright side, the emphasis on improving payments arrangements is to be welcomed. The Fund staff is ready to assist in this area, and, if requested, we will also offer our assistance to the working group that has been established to work out the terms of reference for the new interstate bank.

I stopped in Moscow for a few hours on my return and saw Mr. Gerashchenko, Chairman of the Central Bank of Russia, who was extremely supportive of our work on clearing and settlement systems. He was much less explicit on monetary policy in Russia. I have asked Baron Godeaux to visit several states in the near future, starting with Russia, to see how the Fund can help to revitalize work on clearing and settlement systems.

It was a genuine pleasure for me to attend the opening of the Joint Vienna Institute and the inaugural seminar there. I wish to express my warm thanks to Mr. Prader for his crucial assistance in organizing the series of meetings with the Austrian authorities that resulted in the initiative to create a new Institute. This facility has been warmly welcomed by the transforming countries, which are sending high-ranking officials to participate in courses. The quality of the building provided by the Austrian authorities is excellent; among many other useful features, some accommodations are available, so that participants in courses will not have to pay expensive hotel bills. And there already appears to be an excellent esprit de corps among the staff.

While in Vienna, I met with the new President of Austria, Mr. Klestil, Chancellor Vranitzky, Finance Minister Lacina, and Governor Schaumayer. All were appreciative of the Fund's role in establishing the Joint Vienna Institute, and they were supportive of our strategy in Eastern Europe and the former Soviet Union. I explained the problems inherent in a gradualist strategy, including the possibility that foreign investment would be slowed, inflation might not be controlled, and the financing requirements would be magnified. I also explained to these officials--and in my speeches--that the Fund is not in the business of shock therapy but is committed to providing therapy for a shock that has already occurred. They expressed concern about monetary developments, the decline in confidence in Western countries, and issues of surveillance and systemic stability.

In Albania, I met with the President, the Prime Minister, the Finance Minister and other ministers, the Governor of the Bank of Albania, as well as representatives from unions, enterprises, and the press. My overall impression is that the authorities are clearly committed to adjustment, and that they have taken some important structural steps; progress is particularly noticeable in agricultural reform. I was struck by the poor living conditions in the country; unemployment in the cities is apparently very high. I was also struck by the presence across the country of 700,000 concrete bunkers constructed under the old regime.

There is an urgent need to train government officials in Albania; there are very few officials below the rank of minister with whom the staff can work. The authorities still need help in finding their way around the world, and I tried to advise them about European Investment Bank funding, issues concerning debt, gold, the handling of food aid counterparts, and the workings of the G-24 industrial countries. The social consensus is holding for now, but the Government is concerned about signs of opposition, and some of the trade unions are sensitive to cuts in real wages and social assistance. Press and public interest in my visit was impressive, and I had a good opportunity to explain what a Fund-supported program entails. Finally, I stressed, and the authorities were impressed by, the extent of outside financial support for Albania relative to other recipients.

In Greece, I participated in an excellent seminar on the monetary situation in Europe; the participants included senior officials from Poland, Bulgaria, Romania, Hungary, Albania, Denmark, Portugal, and Greece. We had an interesting exchange of views on recent events in the European Monetary System; one participant suggested that the system suffered from what he called overcredibility. The main topic of debate was the strategy to deal with interenterprise arrears and their effects on the system; apparently, some of the participants from Western countries have not fully grasped the extent of the problem. The Estonians are taking a very hard line; they refuse to provide any bailouts. The Romanians are trying to evolve a pragmatic strategy, which they think could lead to a slow resolution of the problem. No one seems to know how both a change in enterprise behavior and control of credit creation can be achieved without creating moral hazard problems. Several other interesting themes surfaced, such as the importance of positive real interest rates. However, the Romanian authorities felt that, if anything, their monetary policy has been too tight. Others noted that interest rates charged by banks in Eastern Europe could be well above deposit rates, and that inflationary expectations might be significantly lower than the actual rate of inflation.

While in Greece, I saw the Prime Minister and several other government officials. It is interesting to note that this visit might not have been possible just a couple of years ago; in this connection, the efforts of Mr. Filosa's chair were most helpful. The Greek authorities are clearly committed to developing a medium-term fiscal adjustment program as part of the European convergence process. Indeed, in this sense, I found the Prime Minister in a kind of combative mode. The Government has only a tiny majority in Parliament, and, while speaking encouragingly of the authorities' recent efforts, I also urged them to take further action. I noted the significant improvement in the dialogue between the Fund and the Greek Government, probably owing in part to the excellent technical assistance that has been provided, especially in connection with the social security system.

The Executive Directors took note of the Managing Director's statement.

2. CAMBODIA - REPORT BY MANAGING DIRECTOR

The Managing Director made the following statement:

Executive Directors will recall that, on September 11, 1992, the staff informed the Executive Board that management had made a preliminary finding that there exists a governmental structure in Cambodia with which the Fund can work. This finding was to become effective upon the receipt by the Fund of Cambodia's designation of a Governor, Alternate Governor, fiscal agency, and depository. These designations were to be supplemented by assurances from the Supreme National Council and the United Nations Transitional Authority in Cambodia (UNTAC) regarding the legal authority of the governmental structure to act on behalf of Cambodia.

We have now received a communication from the Supreme National Council and UNTAC that, except for the designation of the Governor and Alternate Governor, contains the designations and assurances that we were seeking. We understand that the Supreme National Council is in the process of selecting a Governor and Alternate Governor.

In light of this communication, I have decided to give effect to my preliminary finding, thus re-establishing formal communication between the Fund and Cambodia.

Needless to say, the Managing Director added, work was under way with a group of countries on settling Cambodia's arrears to the Fund.

The Executive Directors took note of the Managing Director's statement.

3. REPUBLIC OF LITHUANIA - STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on the request of Lithuania for a stand-by arrangement for a period of 11 months in an amount equivalent to SDR 56.925 million (EBS/92/157, 9/30/92; and Sup. 1, 10/20/92).

Mr. Fridriksson made the following statement:

Lithuania fought to regain its independence from the Soviet Union at the first opportunity and had, in fact, received recognition by some Western governments in early 1991. Independence was assured following the failed coup in the Soviet Union in August 1991, and Lithuania applied for membership in the Fund in September 1991. Typical of its pioneering ambition, Lithuania was the first of the Baltic states and the former republics of the Soviet Union to become a member of the Fund, on April 29, 1992.

As the staff paper shows, the Fund has had a number of missions in Lithuania, not only from the European II Department, but also a series of technical assistance missions in various areas. On behalf of my Lithuanian authorities, I would like to take this opportunity to thank the staff for its dedication and professionalism.

The Lithuanian economy was mutilated over a 50-year period, and its rehabilitation will be a monumental task. When the program discussions started between the Lithuanian authorities and the Fund, the Lithuanian Government had already embarked upon the transition from a command economy to a market economy. The basic elements of a reform strategy had been defined, and fundamental steps had been taken, particularly in the areas of price liberalization and privatization, where impressive progress had been made. In the program that has been developed with the assistance of the Fund, this strategy has been advanced further and given greater precision.

In the realm of macroeconomic stabilization, the Lithuanian Government had already committed itself to sound and forward-looking policies, with fiscal discipline as a leading principle. This lays a good foundation for meeting the fiscal pressures that are intensifying, owing to the adverse conditions that Lithuania is facing.

If the difficult situation that Lithuania finds itself in is to be successfully dealt with, nothing short of a very strong program will suffice. The program presented to the Board today meets that criterion. It is a very comprehensive program, which addresses the important problems and weaknesses in the Lithuanian economy and the institutional framework. It is clearly described in the staff paper, but I would nevertheless like to emphasize its crucial elements.

The most pressing objective is to adjust the economy to the external shock that has hit Lithuania through the sharp adverse change in the terms of trade. The authorities are committed to passing through the higher energy prices, and, to a great extent, this has already been done. Thus, at the end of August 1992, energy prices were 100 times higher than at the beginning of the year. During the same period, consumer prices increased by 500 percent.

The rapid passing on of the dramatically higher energy costs is closely linked to the commitment to keep the budget under control. In the Board's pre-membership discussion of Lithuania in March 1992 (EBM/92/40, 3/31/92), several Directors were rightly concerned about the risk of a substantial deterioration of the fiscal position in connection with the anticipated terms of trade shock. Even if the full impact of the shock is yet to be felt, the budget was kept in balance through the first half of 1992, and, according to the staff assessment, that--along with the decisions already taken to protect the budget, such as the reductions of subsidies, tight control over social costs, and tax increases--will keep the budget balanced throughout the year. The Lithuanian authorities are committed to taking the additional measures that may be necessary to maintain balance through 1992 and the first half of 1993. Fiscal policy will be supported by a temporary incomes policy to facilitate the adjustment.

As to monetary policy, an important part of the basic institutional framework has been put in place by the creation of a two-tier banking system. The Bank of Lithuania is being reorganized in order to be able to fulfil its monetary policy role, and a government securities market is being created. The Fund and a number of foreign central banks are giving valuable technical assistance in these fields.

Another necessary foundation for monetary policy is a national currency. As Directors will recall, the strategy of Lithuania in this respect has been relatively cautious. The introduction of a national currency, the litas, has been foreseen for some time, but the authorities have been aware of the need for thorough preparations for such a step. It was deemed imperative to ensure that the necessary institutional arrangements be put in place, including the unification of the exchange rate and the introduction of prudential standards for limiting the foreign exchange exposure of banks.

Owing to unforeseen complications, the Lithuanian authorities decided in September 1992 to modify their initial plans to introduce the litas and leave the ruble area. Thus, when Lithuania departed from the ruble area on October 1, 1992, the coupons--the talonai--that had been circulating along with the ruble since spring 1992 were made the only legal tender in Lithuania. During the week preceding that date, rubles could be exchanged for talonai at par. Since then, the rate of the talonas against foreign currencies, including the ruble, has been determined in the market, and it has, in fact, appreciated against the Russian ruble.

The expectation is that the litas will be introduced sooner rather than later, but at a time yet to be determined. The Lithuanian authorities have committed themselves to closely collaborating with the staff on the timing of the introduction of the litas.

As stated, the Lithuanian authorities are strongly committed to a full implementation of the program in close collaboration with the staff. Directors should also be aware that the implementation will be fraught with difficulty. The statistical basis for various aspects of the program is far from perfect. Moreover, although the population is ready and willing to make sacrifices in order to move quickly to a market economy, pressures will undoubtedly emerge during the winter when the tremendous increase in oil prices begins to be seriously felt by households and average wages hardly suffice to cover the basic food basket and the cost of a minimum amount of fuel.

The summer of 1992 was an extremely dry one, with serious consequences for agricultural output, and now winter appears to have arrived early. The start of the heating season had to be delayed, largely owing to a shortage of fuel. In addition to the unfriendliness of nature, there is the difficult trading environment with the Russian Federation and the other republics of the former Soviet Union. An improved payments and settlement mechanism is urgently needed, and all means must be sought to facilitate trade between the various countries that used to belong to the Soviet Union, and that used to have important trade relations. In this respect, the Russian Federation carries a special responsibility. An example of the difficult trading environment is that Lithuania has had to prepay Russia for deliveries of energy resources that have not actually begun. It is essential that trading partners abide by established principles, and that trade be conducted in a nondiscriminatory manner.

In this difficult environment, the authorities have completed all the prior actions agreed in the program, as confirmed in the supplement to the staff paper. The fact that the prior actions were not all in place until last week stems, by and large, from institutional bottlenecks and weaknesses, and should not be interpreted as a lack of commitment on the part of the authorities.

Lithuania has adopted an aggressive program that is worthy of the Fund's support, as well as the support of the international community. The external financing is largely in place, and a full list of commitments within the G-24 framework is contained in Correction 1 to Supplement 2 to EBS/92/131 (9/14/92)--the staff paper on Latvia's request for a stand-by arrangement.

Mr. Prader made the following statement:

I am glad to support the request from the Lithuanian authorities for a stand-by arrangement. Not only does Lithuania clearly have a real need for balance of payments support, but the authorities have also persuasively demonstrated their serious commitment to address all the cumulative problems of the past that have placed Lithuania in such a difficult position today.

I am much impressed by the number of important steps already taken to transform the Lithuanian economy. As in many other former Soviet republics, most prices have been liberalized; and like the other Baltic states, Lithuania has removed foreign trade barriers to expose its economy to foreign competition. However, Lithuania has gone beyond most of the other former Soviet republics in terms of its progress with privatization and avoidance--despite severe strains--of a government budget deficit. Therefore, Lithuania's approach, even more than those of Estonia and Latvia, could serve as a model for the other republics of the former Soviet Union, including Russia.

Many obstacles nonetheless continue to obstruct the efficient working of markets, and their elimination will depend on the authorities' fortitude in making correct but politically difficult policy choices. The greatest challenge now confronting the Lithuanian authorities is finding and adopting the right mix of adjustment and external financing to absorb the serious external shocks stemming from the deterioration of Lithuania's terms of trade and the de facto elimination of its trade flows with the other republics. Here, its low initial level of external indebtness will enable Lithuania to accept even nonconcessional assistance without unduly jeopardizing its medium-term ability to service its debt.

The burden of adjustment will be significant, despite the relatively large amount of external financing that has been promised. Besides the internal misallocation of production resources typical of all former centrally planned economies, Lithuania's productive structures remain seriously misaligned with its comparative advantages, owing to the reallocation of resources within the former Soviet Union. The abrupt introduction of world prices into the Lithuanian economy is now painfully demonstrating the nonviability of its production structure. The severe deterioration of the terms of trade with major trading partners will soon bring significant income losses and force major shifts in the production structure, in order to align it more closely with the new relative prices of exports and imports. In this connection, it is encouraging to note that the authorities have taken the first steps to facilitate market access for new businesses. However, easing the entry of new firms is not the only way of changing the production structure: it is equally important to allow for the exit of those producers that, without state subsidies, cannot remain profitable under the new relative prices. Early effectiveness of the bankruptcy law is, therefore, also essential for quick progress in this area.

When an economy faces a dramatic increase in the prices of its imports, continued price stability is crucial to avoid the inflationary spiral that would result if the increased import costs were passed through to domestic prices. Because a large share of the economy still consists of state-owned enterprises, an important role must be played by incomes policy. I am, therefore, very glad to see that the Lithuanian authorities have decided to curb the growth of real wages by following the wage freeze with a forward-looking--rather than a backward-looking--adjustment of nominal wages. Firm adherence to this principle will enable the authorities' incomes policy to aid in lowering both inflationary expectations and actual inflation to the targeted levels. It is fortunate that Lithuania's currently high monthly inflation rates stem not from large budget deficits or printing press monetization, but mostly from the large increases in import prices. As long as the authorities continue to pursue prudent macroeconomic policies, the prospect for an early reduction of inflation will remain realistic.

As supply becomes more responsive to demand, the internal reallocation of resources, together with the terms of trade shock, will inevitably lead to income losses. The more rapidly Lithuania's productive assets are reallocated to reflect its comparative advantage and new demand conditions, the easier it will be to overcome the terms of trade effects. Ultimately, Lithuania will both export and import at market prices. For most imports, especially energy, these prices will be the same as world prices. Lithuania will be supported during this critical period by external financial assistance, but it must work diligently to complete the profound economic adjustment so as to end its dependence on external assistance in the medium term. The program presented for the Board's approval today represents a significant step in that direction.

Mrs. Sirivedhin made the following statement:

The achievements so far of the Lithuanian authorities in setting up a new legal and institutional framework as a groundwork for further steps in the process of redirecting the economy into a market-based system are impressive. This is evidenced by the forceful prior actions that have been taken as part of a strong adjustment program in the form of the proposed stand-by arrangement. However, economic activity, the terms of trade, inflation, and the employment situation are not encouraging. Lithuania's adjustment and reform efforts warrant the Fund's support, and I can endorse the proposed decision with the following observations.

First, the weak economy means that priority should be given to boosting economic activity. In this connection, the emphasis should be on institutional measures to enhance the supply response. At this point, I attach more urgency to such institutional measures than to the further elimination of price controls. I note that much progress has been made in introducing reform measures, including the liberalization of trade and prices, and the process of ownership transformation. These positive actions should be augmented further, in particular through the nurturing of domestic private entrepreneurship and investment. Diversification of export markets is clearly needed to support product diversification and reduce reliance on traditional markets and products.

Second, the next major task confronting the authorities is to bring inflation down to a manageable level. I am heartened by the authorities' intention to reduce inflation from the average monthly rate of 120 percent recorded during the January 1991-July 1992 period to a monthly rate of 2 percent by early 1993. I note that the authorities intend to make the price system more effective by introducing antimonopoly legislation and other measures to develop stronger competition in the fields of both production and distribution; however, in view of the continued price liberalization and the worsening terms of trade, as well as of the implementation of currency reform, I wonder whether this target is achievable within this short span of time.

Third, the success of Lithuania's economic program depends importantly on maintaining overall budgetary balance. The recent moves by the authorities on both the revenue and expenditure sides are in the right direction. The authorities' maintenance of a stance of matching spending to available budgetary revenue is an indication of their strong determination to achieve the objective of a balanced budget. In these circumstances, drastic measures to reduce budgetary outlays, including through, inter alia, the temporary freezing of wages, the imposition of controls on wage increases, and the elimination of unnecessary jobs in the civil service, are necessary. The authorities' decision to limit the increase in wages in line with the program objective is commendable, and it is important that they not succumb to pressures for full wage adjustment.

Fourth, the privatization program for the public enterprise sector is most welcome, as this will help reduce the burden of public expenditure, as well as improve resource allocation. I note with satisfaction that substantial progress has been achieved in the implementation of the program. Considering the magnitude of public ownership in the economy, the privatization of 600 large enterprises and of more than 76 percent of the total number of state-owned apartments within the short span of one year demonstrates the strong commitment of the authorities. I am pleased to note that there are plans to privatize a total of nearly 3,500 public enterprises by the end of 1993. These proceeds apparently will find their way to the revenue side of the budget; however, I am concerned about the remaining 350 large enterprises, which are placing a heavy burden on the budget and might take considerable time to privatize fully. As the privatization of large public enterprises is an ongoing process, I urge the authorities to establish hard budget constraints in the short run through their commercialization; besides minimizing their burden on the budget, this would be helpful in solving the problem of interenterprise arrears. It would be interesting to learn more about the methodology being used to privatize agricultural land, and about how it is working out.

Finally, the program is not without risks, as the success of its implementation depends on financial support from the international financial community, which, in turn, is dependent on the credibility of the adjustment program. Therefore, the authorities are urged to stand ready to take additional measures if necessary. Considering the large size of the financial need, stemming from the slow pace of world economic recovery, I would be interested to learn whether the authorities have a contingency plan for keeping the goal of reducing inflation intact if the required funds are not forthcoming.

Mr. Esdar made the following statement:

At the outset, I would like to congratulate the Lithuanian authorities for the ambitious reform program on which they have embarked. I was particularly impressed by the early beginning of the privatization program, both for small and large enterprises, and by the progress achieved so far in liberalizing the economy. The determination with which the authorities have proceeded in their efforts is certainly encouraging. Lithuania seems to have reversed the usual sequencing observed in some other transforming countries, where privatization--as the key to an early supply response--has lagged significantly behind the attempted macroeconomic stabilization.

However, macroeconomic stabilization, as well as progress in institution building and structural reform, is a crucial pre-condition to avoid the further deterioration of the economic situation. GDP declined by close to 15 percent in 1991, and the output decline may accelerate in 1992. A severe drought and the de facto standstill in trade with the CIS members have increased the difficulties in Lithuania considerably. A stable macroeconomic framework, based on a prudent fiscal policy and a restrained monetary policy, and supported by an open trading regime, is the precondition for overcoming these difficulties. Important first steps in this respect have been taken. The prudent fiscal stance in the first half of 1992 is an encouraging step in the right direction. However, the staff has pointed to the severe risks and uncertainties that Lithuania will be facing. Therefore, it is essential that the authorities remain committed to the adjustment process, and that they are prepared to react expeditiously and flexibly to external or internal disturbances that may arise in the future.

It is to be welcomed, and it demonstrates the commitment of the authorities to implement the reform program as agreed, that important measures have been taken as prior actions. However, we noted from the supplement to the staff paper that some delays have occurred in the implementation process. Therefore, we encourage the authorities to stick closely to the agreed timetable. The elements of the reform process and their timing are closely interlinked, and delays in implementation in some areas may lead to negative repercussions for other areas, thereby jeopardizing the overall success of the reform process.

I can broadly endorse the program as presented, and I have only a few comments in some policy areas. Budgetary discipline has to be the cornerstone of any attempt to keep inflation under control. The Government's target to achieve a balanced budget for the program period appears ambitious but adequate, in light of the distortions that could result from an inflationary financing of the budget deficit. I noted the staff's view that the announced or implemented measures would be sufficient to achieve this balance; however, I wonder whether we could get more information on the period after mid-1993, considering, in particular, that Table 6 in the staff paper covers only the period until end-1992.

In addition, while I noted and welcome the commitment of the authorities to introduce additional measures--if the need should arise--I wonder whether there is sufficient implementation capa-city to achieve the desired outcome, especially on the revenue side. In this respect, I noted the considerable technical assistance that has been provided by the Fund in the fiscal area; I would appreciate staff comment as to whether this support has achieved the expected results.

A cautious fiscal policy course should facilitate the task of monetary policy. The introduction of a new currency is certainly an important step that should be implemented as soon as possible, provided that the necessary institutional framework and administrative capacity exist for the conduct of a prudent monetary course. In this respect, an early restoration of positive real interest rates should help to reduce inflationary pressures and prevent the emergence of capital flight.

While monetary policy will probably be conducted in somewhat uncharted waters for some time, incomes policy has a major role to play as an additional nominal anchor. In this context, although I respect the political motivation for not relying on tax-based incomes policies, I wonder what steps have been taken or are envisaged to safeguard the implementation of the announced wage guidelines, which, in my view, are appropriate.

In the external sector, as indicated in the staff's medium-term outlook, a viable balance of payments position can be achieved only if export performance can be improved substantially. In general, it is of some concern that the medium-term viability of the balance of payments remains rather uncertain. In this regard, the intention to remove export restrictions and take further measures to liberalize the trade regime are important steps. We agree that, in the long run, there has to be a reorientation of Lithuanian exports to established market economies, and it remains a challenge, particularly for industrial countries, not to obstruct the prospects for an improvement in Lithuania by applying protectionist measures. However, it is important at the same time to rebuild orderly trade and payments arrangements with the other states of the former Soviet Union. The persistent problems and disturbances in trade and payments relations are a source of great concern, and I should like to support the Managing Director's repeated initiatives for a more cooperative approach by all participants in this crucial area, although, admittedly, not all to whom the message has to be addressed are represented yet in this room.

Mr. Dawson said that he endorsed those carefully worded comments. He then made the following statement:

Lithuania is making important progress in transforming itself from a centrally planned economy into a market-oriented one. The dislocations involved have been compounded by the disintegration of traditional trading and financial relations with the other countries of the former Soviet Union, and by the delayed--but now wrenching--adjustment of energy prices to world market levels. Real GDP went down by about one third in the past two years, and the slide is expected to continue into next year.

In the face of this adversity, the Lithuanian authorities have shown a strong sense of purpose and an admirable tenacity in trying to stabilize and restructure their economy. Price liberalization has been virtually completed, and most of the energy price jump is being passed through to consumers.

Privatization is making good headway. We are particularly impressed that apartments have been widely privatized, giving the citizenry a strong stake in the success of the transformation to a market economy. Budgetary discipline has been well maintained, although the most serious tests are only now emerging.

The institutions of economic management are not well developed in Lithuania. A lot of "learning by doing" will be required to make a success of the stabilization effort on which the authorities have embarked. The program before us reflects these inescapable realities. The review standards focus almost as much on operational improvements in policy implementation as on quantitative performance criteria. Given the fluidity of the economic situation and the shaky statistical grounding of the program, we think that this approach is entirely appropriate for the first 11-month stand-by arrangement.

Monetary arrangements in Lithuania are evolving rapidly. The essential elements of money and credit control and banking supervision are addressed in the program in ways that try to allow for anticipated institutional developments. However, much improvisation and uncertainty remain.

Prompt clarification will be needed of how monetary reform is to proceed. Earlier, it was expected that a new currency, the litas, would be introduced only after a transitional arrangement that made use of a coupon, the talonas. Events, however, have forced the early conversion of the talonas into full-fledged, exclusive legal tender. We believe that this was the correct response, as the coexistence of the coupon and the ruble was leading to degenerative monetary arrangements. The fact that the talonas has appreciated 30 percent relative to the ruble reinforces the impression that the authorities made the right decision.

However, now that a separate currency has been introduced, it will need to be managed as a separate currency. The authorities will need to begin immediately to establish their reputation for prudent monetary management. The arrangements for bank-by-bank credit ceilings are a pretty blunt--and nonmarket--approach to monetary control. We understand its necessity as a transitional device, pending development of more sophisticated monetary control mechanisms; however, controls on bank lending will not be adequate if bank liquidity is not contained. The new Bank of Lithuania refinancing facility, operating under an auction system, appears to be an attractive mechanism for both disciplining bank liquidity and introducing more market-sensitive, indirect means of controlling money and credit. We look for the rapid evolution of these arrangements and an early switch away from bank-by-bank credit control.

The authorities still intend to switch from the talonas to the litas in the not too distant future. What further changes in monetary policy are expected to be entailed? The current deposit structure includes a substantial proportion of foreign currency liabilities. Does this indicate extensive dollarization of the economy? The current arrangements provide for a floating exchange rate. Is there an expectation that the switch to the litas would include adoption of an exchange rate peg or perhaps a currency board arrangement? Staff comment on these questions would be appreciated. There is an intriguing sentence in the supplement to the staff paper, stating that "the monetary authorities agreed to advise the commercial banks to change the fixing procedure in future by using daily quotations so as to rule out profitable arbitrage opportunities for market participants." Profitable arbitrage opportunities should surely be an article of belief of the Fund.

The staff supplement seems to provide some good news on recent monetary developments. Lithuania's net correspondent balance with the other ruble countries has improved substantially since June 1992, and the net domestic assets of the central bank are considerably smaller than had been anticipated. We would like to believe that this is a harbinger of firm monetary control, but the write-up gives the impression that it is just a by-product of the turbulence associated with the adoption of the talonas as legal tender and the lags in payments by the Government. We would appreciate a more detailed explanation of these developments by the staff.

Whatever the exact details of monetary arrangements may be, fiscal discipline is indispensable if monetary control is to be maintained, as there are no established channels for nonmonetary financing of government deficits. So far, Lithuania's experience is good. A budgetary surplus was established in 1991 when the terms of trade improved temporarily. The budget situation has turned more precarious this year. Demands have escalated as the economy has slumped and the terms of trade have reversed. The authorities have shown impressive resolution in improving tax collection and containing spending--even while the economic base has fallen away. This effort will need to be continued, as much of the economic loss that Lithuania has experienced can be restored only through restructuring, rather than through simple reactivation.

There is a clear inconsistency between the slump in economic production that Lithuania has experienced and the real incomes that workers are continuing to record. Despite the slump, hardly any unemployment has emerged, and real wages have hardly changed. The stand-by program calls for an incomes policy that would systematically cut real wages by about 30 percent to bring output and income into better alignment. Nominal wages would stand still for a couple of months while high, but receding, inflation rates eroded their real value. The adjustment is unlikely to be as tidy as implied by the staff paper, but a systematic framework of this type is needed to push the economy as quickly as possible into a more stable balance between what people earn and the available resources.

It is not enough that the suit be cut to fit the cloth. For the long-run well-being of Lithuania, major structural changes must be fostered. The privatization of small enterprises and apartments seems to have made good progress, but it is hard to reconcile the privatization numbers with the lack of adjustment in employment. The unmistakable impression is left that the major employers have not yet had their customary working arrangements disturbed. Experience in Eastern Europe shows that radical changes in products, markets, and production techniques are needed to meet the needs of a market-oriented economy. We would be interested in receiving further background from the staff on how the reconstruction of the productive heart of the Lithuanian economy is expected to proceed.

The stand-by arrangement looks for a current account deficit over the program period of $500 million, or 10 percent of GDP. Given the unreliable statistical base and the fluid nature of economic developments, this estimate needs to be taken as a rough approximation. Even so, this is a very large deficit for a country with few established external financing channels. It now appears that financing will be found to cover the deficit. This much is encouraging; going forward, however, we believe that it would be unwise for the authorities to build their plans on the expectation of repeated, large-scale gap-closing exercises. The best strategy that Lithuania could follow would be to push the adjustment efforts to the limit, thereby simultaneously reducing the need for external support and improving the likelihood that such support will be available.

We believe that Lithuania's program is a very good one, which we are happy to support.

Mr. Bonzom made the following statement:

I would like, at the outset, to welcome Lithuania as a new member of the Fund and join previous speakers in commending the pioneering role that it has played--and, in many respects, continues to play--in the reform movement within the former Soviet Union.

Such a role could not have been played without the impressive consensus and commitment for reform that has, by and large, prevailed in Lithuania, including--as the Managing Director stressed, in summing up his impressions from his visit to Vilnius in August 1992 (BUFF/92/123, 8/28/92)--during the current electoral period. This will constitute a major asset in the times ahead, when Lithuania will have to face the consequences of the relatively recent terms of trade shock, of what Mr. Fridriksson calls the "unfriendliness of nature," and the consequences of the pattern of noncoordination that still too often characterizes the economic relationships among the states of the former Soviet Union. This latter reality has, in the case of Lithuania, translated into inflows of rubles that have been difficult to control, interrupted trade, and demands from Russia for advance payment of imports. As one of the assumptions behind the GDP projection in the program under discussion is the resumption of normal energy trade with Russia, we fully agree with the staff that the early resolution of interrepublican issues will be critical for the smooth development of the stabilization and reform strategy.

If one adds to this major source of uncertainty the challenges of a sharpening decline in activity over the 1990-1992 period and the risk of hyperinflation, the very difficult circumstances facing Lithuania appear even more clearly. In such a context, we are convinced that the full range of policies that has been defined by the authorities goes very much in the right direction. As we agree with the thrust of the staff appraisal, and with many of the comments made by previous speakers, I would at this stage of the discussion like to make the following remarks.

First, the authorities' commitment to a balanced budget is highly commendable. It is welcome that earlier worries on the budgetary outcome for 1992 will probably not materialize. However, the fact that the 1992 surplus will be due not only to the additional measures taken, but also--in part--to temporary factors related to the terms of trade, points to the need for continued vigilance. Revenue performance should be closely monitored;

welcome steps have already been taken during the past few months in this regard. Above all, the authorities are right to place high priority on controlling expenditures and, especially, on improving the targeting of the social safety net. They have already built a strong record in reducing subsidies, which are scheduled to diminish from 5.4 percent of GDP in 1991 to 1.8 percent in 1992. This has been achieved, chiefly by a large passing through of energy prices. In the circumstances, the authorities are certainly justified in trying to protect the use of household energy through a policy financed by the taxation of other uses of energy. This policy will also encourage conservation in other sectors of activity. However, we agree that such a policy should be temporary: it should be phased down and replaced by more targeted instruments.

Second, on monetary policy, we welcome the recent clarification and improvement in the relationships between the central bank and the authorities in charge of economic policy. Such an arrangement will help maintain the restrained monetary stance that is indispensable if Lithuania is to contain hyperinflationary pressures. In order to achieve this aim, it seems fully appropriate that direct control methods have been chosen, and that these methods have been devised in a way that should not penalize new banks, as the authorities will thus have some time to experiment with the recently introduced indirect control instruments.

I would be grateful if the staff could elaborate further on the reasons why the interenterprise arrears problem is not as severe in Lithuania as elsewhere. More specifically, is not this welcome reality linked in part to the fact that the disruption provoked by the rise in energy prices occurred relatively recently in Lithuania?

Third, we welcome the recognition included in the program that adjustment in real wages will be needed. Given the authorities' reluctance to implement a tax-based incomes policy, the chosen course, which involves a temporary freeze, the imposition of a series of guidelines, and the legal possibility to take direct action, will have to be pursued with determination.

Fourth, it is safe to assume that structural reforms will play a major role in reviving activity. We welcome Lithuania's pioneering role in the area of price liberalization, as well as the fact that such a stance has been accompanied by the specification of antimonopoly provisions. Similarly, the rapid move toward privatization has been appropriately complemented by measures affecting commercialization, foreign direct investment, and the promotion of modern methods of accounting. As stressed by Mr. Prader, the introduction of bankruptcy provisions will also be crucial. Such a course of action should be pursued, together with a further liberalization of export taxes and an improvement in the statistical framework. In this latter area, as well as in others, technical assistance is warranted.

The implementation of the current program will be crucial in at least three respects. First, it will help Lithuania overcome the fragility of its economic situation. This fragility is highlighted in the staff's medium-term scenario by, inter alia, the persistence of a rather low--although increasing--ratio of reserves to imports. Second, the program will constitute an incentive for the international community's support of Lithuania's efforts. In this regard, it is hoped that decisions by all G-24 industrial countries will bring about a balanced burden sharing. Finally, the program lays the proper framework for the success of the national currency strategy.

All these elements, together with the impressive range of prior actions and the commitments of the authorities, lead us to fully support the proposed decision.

Mr. Posthumus said that, like Mr. Dawson, he wished to underline the importance of the issue raised by Mr. Esdar, namely, the harm that could be done to relations among the CIS members by raising barriers to trade. The appraisal in the staff paper had rightly emphasized that problems in settling interstate payments had been a major factor in undermining Lithuania's trade with the CIS members, and that the success of its economic program could depend critically on the early resolution of those issues.

The supplement to the staff paper indicated that, despite continued negotiations between the two Governments, some problems remained in the trade and payments system linking Russia and Lithuania, Mr. Posthumus continued. However, the staff appraisal contained in that supplement had made no further mention of those issues. Therefore, the extent of the progress, if any, made in solving those problems since the issuance of the staff paper on September 30, 1992 was not clear. Apparently, the Russian authorities were continuing to impose export taxes and collect in advance for deliveries of energy resources that had not yet begun.

In his report to the Board at the beginning of the Board session, the Managing Director had noted that Baron Godeaux and others would be in Russia shortly to discuss clearing and settlement issues, Mr. Posthumus recalled. He wondered what strategy the Fund intended to apply in dealing with those problems, which, as they became more serious, were posing a greater threat to the success of Lithuania's program.

The Chairman remarked that the countries involved were being reminded not only of their obligations as Fund members to arrive quickly at concrete, amicable solutions to clearing and settlement problems, but also of the importance that such solutions would have for the success of their economic programs.

Mr. Prader commented that, in addition to the trade barriers affecting CIS members, there were widespread obstructions to trade among the Eastern European countries. For instance, owing to transportation problems, it apparently took two to three days to cross the border between Poland and Lithuania. In light of the disincentive to foreign investment posed by such barriers, it would be helpful if the Fund could use the program negotiation process to exert its influence on those countries.

The Chairman responded that the establishment of only one "checkpoint Charlie" to handle all the road traffic and trade between Poland and Lithuania was at the heart of the problem. The matter had been discussed with the authorities during his visit to Lithuania, as Mr. Fridriksson would recall. The diplomatic missions in Vilnius and Warsaw were also pressing the two countries to settle those concrete problems, which, apparently, were a difficult undertaking.

The staff representative from the European II Department said that the budget for 1993 would be introduced within about a month. Based on the satisfactory record compiled by the Government thus far, there was no reason to doubt the authorities' stated commitment to maintain a balanced budget. In addition, as was mentioned in the supplement to the staff paper, the Government had recently succeeded in obtaining parliamentary approval of a statutory incomes policy that would enable it to impose wage guidelines on the government and state enterprise sectors. However, the task of balancing the budget would become more difficult in the coming year, given that the trend of rising unemployment and declining output was expected to continue.

Thus far, the authorities had managed the institutional aspects of fiscal policy well, the staff representative noted. Further technical assistance from the Fund in that area was envisaged; in particular, a December 1992 mission was being planned by the Fiscal Affairs Department to lay the groundwork for a new system of budget and expenditure control in the Ministry of Finance.

The fall in the level of the central bank's net domestic assets in the third quarter of 1992 had been due mainly to the stronger than expected budgetary performance, the staff representative observed.

It was not clear why interenterprise arrears had been less of a problem in Lithuania than in the other republics of the former Soviet Union, the staff representative remarked. Certainly, terms of trade losses in Lithuania had lagged behind those recorded in either Estonia or Latvia, and even the most recent data provided no evidence of a substantial increase in interenterprise arrears. As was pointed out in the staff paper, the program did not allow for credit operations designed to unwind the arrears problem.

Imposing credit limits on a bank-by-bank basis was a rather crude form of monetary control, the staff representative considered; however, in the absence of a functioning financial market, and with only untested instruments of indirect control available, it had seemed more prudent to use direct instruments. Nevertheless, as was indicated in the staff paper, the intention was to switch to indirect policy instruments once they had been fully tested.

Because of its political sensitivity, land privatization had lagged behind the privatization of other sectors of the economy, the staff representative noted. However, with the World Bank's assistance, the authorities intended to settle all questions of land reform. Moreover, in keeping with the strategy outlined in paragraph 57 of their memorandum of economic policies, the authorities were determined to work with the World Bank to restructure and improve the performance of the state enterprises.

The authorities had not yet decided on the exchange rate arrangement that they would use once the talonas had been replaced by the litas, the staff representative reported. Probably, after the litas had stabilized, its rate would be fixed against a basket of currencies. Since its introduction, the talonas, which has been allowed to float freely, had moved very little against the dollar; however, it had appreciated by about 30 percent against the ruble, which, in turn, had depreciated sharply against all convertible currencies.

The failure to make daily adjustments of all exchange rates had caused some commercial banks to quote broken cross rates, the staff representative added. The problem had disappeared when, following the advice of the monetary authorities, the banks had begun to use daily quotations.

As was noted in the supplement to the staff paper, Russia was currently demanding prepayment in hard currency for its energy exports to Lithuania, the staff representative remarked. In addition, because of the export taxes levied on those deliveries, the prices were higher than world market levels. Those issues--which were being negotiated by the two countries, graphically demonstrated the linkage between the political and economic problems affecting the republics of the former Soviet Union.

As the financing for the program seemed to have been largely secured through the G-24 process, the question of whether contingency plans had been drawn up on that account had become less urgent, the staff representative from the European II Department suggested. The first disbursement of the European Community funds, which accounted for half of the G-24 financing, was expected to be made in December 1992. Clearly, however, if external assistance were not forthcoming, output and employment would shrink further, exchange rate pressures would intensify, and the inflation rate would rise.

Mr. Shimizu made the following statement:

Like previous speakers, I would like to start by welcoming Lithuania's membership in this institution and its request for a stand-by arrangement. This chair highly commends the authorities' commitment to transform their economy into a market-based one and the actions that they have taken thus far.

One of the keys to the success of the authorities' stabilization program is to maintain tight financial policies. In this regard, it is welcome that a balanced budget in the second half of 1992 is expected to follow the surplus in the first half of the year, thanks to the authorities' measures to raise revenue and reduce expenditure.

Turning to the 1993 fiscal situation, the staff concludes on page 10 of the paper that "these actions...appear adequate at this stage to keep the general government budget in balance through the middle of 1993." As a further decline in output--which would have adverse effects on revenue and expenditure--is expected in 1993, this assessment may be optimistic. Perhaps the staff could give us some idea of the contingency measures that the authorities can take if the fiscal position becomes worse than expected.

The authorities' replacement of the ruble with the talonas as legal tender on October 1, 1992 will increase their maneuverability in controlling inflation, but it will not guarantee a low rate of inflation. It is, therefore, imperative for the central bank to acquire the skills necessary to control the monetary aggregate as soon as possible. In this regard, I welcome the fact that the Fund and many countries are providing the authorities with technical assistance.

I am somewhat concerned that the authorities' incomes policy is not sufficiently strong. The other two Baltic countries accepted a more severe decline in real wages. As incomes policy could be an anchor to stabilize the economy, I look forward to seeing a stronger incomes policy by the time of the next program review.

On structural policy, I welcome the fact that the authorities have successfully proceeded with privatization, especially with respect to small enterprises. As one year has passed since the first privatization, an assessment of the experience to date would be worthwhile. One of the main objectives of privatization is to enhance economic activity and the supply response. I am, therefore, interested in hearing from the staff about the kinds of effects on economic activity and the supply side that have been observed so far.

Finally, on the external sector, because Lithuania depends on the former Soviet republics for most of its trade, it is imperative to restore trade with these countries. Deficiencies in the payments system in the ruble area are one of the major reasons for the collapse of interrepublican trade. I am concerned that the introduction of the new currency might make the situation worse; the staff's comments on the effects of this action would be welcome.

In order to gain medium-term balance of payments viability, it is important to attract foreign direct investment, so as to increase export capacity and obtain management skills and techniques from abroad. The staff reports on page 21 of the paper that there are "significant investments in Lithuania by foreign firms." I would be interested in learning more about the sectors that are attracting foreign investment, and where the investment is coming from. I support the proposed decision.

Mr. Martínez-Alas made the following statement:

The rapid progress of the Lithuanian authorities in transforming their legacy of centralization into a free-market-oriented economy is to be commended. Most prices are now market determined, and significant progress has been made in privatizing small business, households, and agricultural land. In this connection, we encourage the Lithuanian authorities to swiftly remove the remaining restrictions on land sales, so that real asset markets can work efficiently.

Lithuania's prior actions and program are very comprehensive and coherent. The perseverance of the authorities in implementing the adjustment program will be instrumental to its success. We have some misgivings, however, about the measures relating to employment and wages in Lithuania. In light of the output collapse, we fully understand the concern of the authorities to protect the standard of living through wage indexation and regulations prohibiting the shedding of labor. We would like, nonetheless, to encourage them to move more rapidly to a system in which enterprises can retain and hire labor according to their needs--and not for welfare reasons. If enterprises are going to react efficiently to market price signals, they must have the freedom to choose the most profitable combination of production factors, including labor. In this regard, the wage freeze and the permitted reduction in the size of the enterprises' labor forces are steps in the right direction; however, bolder and quicker actions seem to be needed in this area.

The authorities have been preparing the way for a smooth transition to a new currency. As explained in Mr. Fridriksson's opening statement, the first phase of the introduction of a national currency has been successfully completed. We welcome the actions already taken to establish the necessary institutional framework for managing an independent monetary policy.

Lithuania, like the Baltic state of Latvia, has chosen a flexible exchange rate arrangement. We understand that the Lithuanian authorities are fully aware of the importance of tight financial policies in sustaining a stable exchange rate under a flexible, market-determined arrangement. In this connection, the progress made on the structural measures related to budget planning and management, the use of monetary policy instruments, and the financial restructuring of the banking system, respectively, will be of crucial importance for the success of the flexible exchange rate arrangement.

We understand that the Lithuanian authorities, like most policymakers in emerging democracies elsewhere in the developing world, are facing institutional constraints. Most of the time, these constraints slow the pace of program implementation; institutional weakness can sometimes even be an important obstacle to implementation. In this connection, we would like to emphasize once again the utmost importance of the institution-building process for economies in transition, as well as for the developing nations in Latin America and Africa that are embarked on ambitious adjustment programs.

Finally, we are glad to support the proposed decision in light of the important prior actions already taken, and because the Lithuanian program is strong enough to deserve the support of the Fund and the international community.

Mr. Noonan made the following statement:

This chair admires the spunkiness of Lithuania's efforts to adjust to a market economy and integrate with the rest of the trading world. Like others, we are not impressed by the extra burden imposed on Lithuania by Russia's requirement of prepayment for energy products at higher than world prices, as outlined in Mr. Fridriksson's opening statement and the staff's supplementary paper.

The collapse of the old command economy, the difficult trade relations with members of the former CMEA, and a large negative terms of trade shock have led to a sharp decline in Lithuania's real output. Despite these difficulties, the authorities have managed to keep their budget in near balance, limit the growth of money and credit, and make significant progress in implementing structural reforms. In particular, we are impressed by the extent to which price liberalization and the privatization of medium-sized and larger state enterprises have progressed--although I note that they still account for a substantial share of economic activity in Lithuania.

I would, therefore, like to join with others in the assessment that the prior actions and the strength of the Lithuanian reform program merit the Fund's support. I have only a few brief comments to add, mainly on pay policy.

With the last installment of the Baltic "trilogy" about to be completed, I agree with Mr. Prader that this Board now has a useful benchmark with which to assess the economic policies of the other former Soviet republics in transition toward a market economy--some of which face much better economic circumstances than the Baltic states. For those republics that face a less severe negative adjustment to their terms of trade--or, indeed, a significant increase--it would be difficult to justify slower progress in implementing structural reforms and taking appropriate macroeconomic stabilization measures than that being made by the Baltics. Moreover, the cooperation between the Baltic states and the Fund, which has resulted in the approval of three stand-by arrangements in just over the year that has elapsed since applications for membership were received, demonstrates that this institution can move expeditiously in its support of sound economic programs when there is a strong commitment to reform, and when appropriate policies to enable macroeconomic stabilization and eventual recovery are being pursued.

More specifically, the scale of privatization--and the rapidity with which the Lithuanian authorities have proceeded with it--deserves to be highlighted and, moreover, commended. Nevertheless, there has been little change in unemployment--a point brought out by Mr. Dawson--despite the sharp decline in output. This suggests substantial labor hoarding by state enterprises. In addition, given that average real wages in the first half of 1992 were about 90 percent of the level that prevailed in 1990, there seems to be little incentive for labor to move out of the state sector and into the private sector. It should be stressed that the adaptation of the newly privatized Lithuanian firms to the international trading environment will require a more flexible labor market.

While we agree with the staff and the authorities that a temporary incomes policy would help wages in the state enterprise sector to adjust to the recent large, negative terms of trade shocks, we are concerned about two aspects of this policy. The first question--similar to Mr. Esdar's query on enforcement--is on the means of implementing this policy in vital sectors, where there may be some reluctance on the part of workers with so-called industrial muscle to accept real pay reductions in the harsh circumstances described by Mr. Fridriksson in his statement, and where average wages hardly suffice to cover the basic food basket and the cost of a minimum amount of fuel. The other concern is that this policy may add to the rigidity of the labor market. Are there any safeguards to ensure that across-the-board wage indexation in the state sector does not distort productivity differentials by preserving the wage structure inherited from central planning? Comment by the staff on this point would be appreciated.

Mr. Mwananshiku made the following statement:

The prior actions taken by the Lithuanian authorities, particularly in the areas of price and import liberalization and privatization, reflect their strong resolve to achieve a speedy transformation of their economy into a system based on market mechanisms. We believe that the current program, ambitious as it seems, represents a move in the right direction, and that support from the Fund would be very useful in complementing and catalyzing resources from other sources. We can, therefore, support the proposed decision.

Given the constraints imposed by the limited institutional capacity in the economy, the disruption of the trade and payments arrangements among the republics of the former Soviet Union, and the emergence of adverse terms of trade in 1992, the authorities face a difficult task in establishing a stable macroeconomic environment, and in building a foundation for sustained economic growth.

As I am in general agreement with the staff appraisal and recommendations, I will, therefore, limit my intervention to a few points only. First, the sustainability of the adjustment momentum depends critically on the ability of the authorities to maintain a disciplined fiscal policy. The efforts to reduce expenditures and raise the level of revenue receipts would be substantially enhanced if satisfactory progress were to be achieved in structural reforms--including the privatization and commercialization of public enterprises--and if an incomes policy were to be put in place and sustained. The relevance of an early economic recovery must also be emphasized, as experience shows that it is difficult to pursue fiscal consolidation in an environment of prolonged recession.

Second, the monetary policy stance remains appropriately restrained. However, its effectiveness in the management of the economy is likely to remain constrained by the underdeveloped nature of the financial system. For example, the absence of a market for government securities makes monetary financing of government deficits difficult to avoid and could blunt the effectiveness of monetary policy. While we commend the authorities for the institutional reforms that they have already implemented, including the introduction of a national currency, we see these as limited and argue for a more aggressive approach. Technical support from the Fund and the World Bank will be important in helping the authorities to set up the institutions necessary for the smooth functioning of the financial system. In addition, the authorities should consider enlisting foreign equity participation in the banking industry as part of their privatization efforts, and as a strategy for attracting much-needed high-level manpower into this sector.

Third, within the limit of the absorptive capacity of the economy, it is important that adequate financing be provided to stimulate private sector activity. In this regard, I agree with the staff that targeting net domestic assets rather than bank credit would facilitate the channeling of foreign financial inflows to assist private sector activity. This would, however, depend critically on the extent to which the Government can exercise financial discipline by sterilizing the domestic currency counterpart in the Bank of Lithuania, and, more important, on the willingness of the donor community to provide such assistance.

Finally, on exchange rate policy, I commend the authorities for the progress that they have made so far and note their plan for further liberalization. However, the extent to which the authorities can maintain exchange rate stability, given the low level of their reserves and the uncertain prospects for the early revival of external sector performance, is a cause for concern, and events in the Russian Federation, as well as the continuous decline in the value of the ruble, confirm my fear. I would appreciate the staff's comments in this regard.

Mr. Thomas said that, despite the terms of trade loss and the dislocation of output that had followed its independence and the collapse of the former CMEA arrangement, Lithuania had made commendable progress so far in the transition to a market-based economy by taking important steps, such as liberalizing prices and privatizing enterprises. However, real income had been maintained, and, by means of a series of regulations, the open unemployment rate had been restricted to only about 1 percent of the labor force. Through those actions, the authorities had succeeded in putting off the needed adjustments--but at the cost of perpetuating the distortions in the system and ingraining inflation into it.

In that context, his chair attached considerable importance to incomes and employment policies, Mr. Thomas commented. The challenge before the authorities was to spread the burden of adjustment across the population, and to accelerate progress toward price stability. At present, it was critically important that the authorities closely adhere to a strong incomes policy, so as to prevent a wage-price spiral. Equally important would be an emphasis on fiscal discipline, which would help to avoid recourse to money creation. Performance under the program--in real terms--would thus depend on the control of inflation, as it could instill domestic and foreign confidence in both the national currency and the Government's economic policies.

The authorities' commitment to balance the budget was welcome, Mr. Thomas remarked. In that context, his chair wished to stress the contribution that monetary policy and banking sector developments could make to the attainment of that overall objective. Bank credits to enterprises were a cause for particular concern; any laxity in that area could undermine the larger monetary objectives, and the revival of the banking system's health could eventually entail substantial budgetary costs. Close monitoring of the banking system's domestic assets--in particular, the development of credit--was essential.

Another concern was the sensitivity of Lithuania's economic performance to the availability of oil and gas supplies from Russia, Mr. Thomas noted. Lithuania's objective must be to purchase oil and gas from Russia on the same terms and conditions as other countries. He joined other speakers in hoping that the authorities of the two countries would come to an amicable understanding on that matter; however, he was not sure how and when such an agreement could be reached, especially as Lithuania had not accepted responsibility for any of the former Soviet Union's external debts. Any additional staff comment on that topic would be welcome.

The risks and uncertainties facing Lithuania were clear, Mr. Thomas stated. However, they must always be balanced against the envisaged policies and the authorities' record. The program was good, and his chair could support the decision.

Mr. Dorrington said that he, too, could strongly support the stabilization program; although the uncertainties remained substantial, it was wide-ranging, as it needed to be. Like other speakers, he commended the authorities for the measures that they had taken so far. At least as important, they appeared to be strongly committed to maintaining and building on the progress that they had made in difficult circumstances.

The fiscal measures outlined in the paper were vital, Mr. Dorrington stated. Any failure to maintain a tight policy into the coming year would bring with it a significant risk of uncontrolled inflation and capital flight, which would put the program off track. In that context, a strong incomes policy was particularly important. The figure of 30 percent cited as the required downward adjustment in real wages was, inevitably, very uncertain; on the face of it--and compared with other countries with smaller terms of trade losses--it might look modest. Any further explanation that the staff could give on the derivation of that figure would be of interest.

Although it now appeared that the current adjustment would, in fact, be somewhat greater than 30 percent, if evidence emerged that the required adjustment was even larger, it would be important not to wait until after the program review in February 1993 to take action. Of course, as other speakers had said, the ultimate objective should be the achievement of an efficient labor market, which would eliminate the need for such an incomes policy.

With respect to monetary policy, it was important to stress that the introduction of a new currency was not an easy option, Mr. Dorrington continued. Monetary stability would depend on the creation of an effective central bank and the development of a competitive and well-regulated commercial banking sector that was allowed to operate on market principles. The Lithuanian financial system was still in the very early stages of development. Despite substantial Fund technical assistance--which, obviously, was extremely welcome--the new central bank was likely to be unfamiliar with instruments of monetary control, and state-owned banks could be a significant burden on the budget. Financial sector restructuring remained of central importance to the efficient functioning of monetary policy, and, more generally, to the functioning of the economy as a whole.

The staff's medium-term balance of payments projections showed that financing gaps as a proportion of GDP would be large over the next few years, Mr. Dorrington noted. In that context, he wished to underline what the staff had said about the uncertainty of those figures. Although it would be very difficult to make precise forecasts, a strong, credible program had the potential to bring with it large flows of foreign investment and capital. Of course, if the program went off track, the reverse would hold. While the international financial community would no doubt be supportive, it should not allow itself to become obsessively wed to particular figures. The key to the success of the program would ultimately be the commitment of the people of Lithuania themselves.

Finally, on a procedural point, Mr. Dorrington suggested that when a supplement to the staff paper needed to be circulated in advance of a Board meeting, it should be done at least two to three days in advance. In the case of Lithuania, important information on both prior actions and monetary performance needed to be circulated; however, it was particularly regrettable that the supplement had not been received until after 4:00 p.m. on the day before the Board meeting. He appreciated that the prior actions were not all in place until the preceding week, but he failed to understand how that justified the length of the delay. He hoped that such late circulation could be avoided in the future, even though late circulation was much better than none at all.

The Chairman said that note had been taken of Mr. Dorrington's points on circulation periods, which Mr. Clark and his working group were attempting to normalize. The staff would try to respect the conclusions of the group.

Mr. Al-Tuwaijri made the following statement:

The Lithuanian authorities have embarked on a strong and comprehensive economic transformation program. As highlighted by the staff paper and Mr. Fridriksson's statement, the authorities have already implemented significant and impressive measures in the areas of price and exchange and trade liberalization, privatization, and monetary, legal, and institutional reform. Moreover, the program will benefit from the existence of a disciplined fiscal policy during 1991 and the first half of 1992. Nevertheless, economic transformation will inevitably entail significant difficulties. However, the authorities' firm grasp of the issues that need to be addressed and their strong commitment to persevere with the transformation process augur well for the success of their efforts.

The decline in economic activity has been aggravated by Lithuania's heavy dependence on trade with the former Soviet Union and the dramatic terms of trade shock that it has experienced. This decline has been compounded by the disruption in the trade and payments system, which has been accompanied by a rapid buildup in interstate payments arrears. Clearly, the success of Lithuania's economic program depends to a large extent on the resolution of the problems of interrepublican trade and interstate payments arrears. Therefore, I am encouraged that, despite the authorities' strong and understandable desire to expand trade with countries outside the ruble area, they recognize that the CIS members remain Lithuania's major trading partners and attach great importance to improving trade relations with them.

Turning to the adverse terms of trade shock, I join the staff in supporting the authorities' strategy of spreading the income loss widely by restraining wages. In this context, the nominal wage freeze for September-October 1992 is expected to reduce real wages by more than 30 percent. While this reduction is substantial, it appears necessary if output, employment, and incomes losses are to be contained. Moreover, the forward-looking wage guidelines, beginning in November 1992 and based on the inflation targets set under the program, are appropriate. Also, I am sympathetic to the authorities' reservations against tax-based enforcement mechanisms for incomes policy because enterprises can easily circumvent these mechanisms.

Appropriate stabilization measures are an essential component of any economic transformation program. Clearly, disciplined fiscal policy is of the essence. However, in the case of Lithuania, where a new currency has been issued and a market-determined exchange rate has been adopted, a tight fiscal stance is all the more imperative. Hence, I welcome the authorities' short-term, revenue-raising and expenditure-reducing measures. As the staff paper indicates, these actions, along with the Government's commitment to implement additional deficit-reduction measures, appear adequate to keep the general government budget in balance through the middle of 1993. However, I note that the authorities converted specific excise taxes on petroleum products into ad valorem rates, which the staff indicates may be raised even higher. Here, I would caution against excessively raising taxes on petroleum products, especially as the price of petroleum in Lithuania has risen dramatically in the recent past, and as the authorities are committed to fully pass through to consumers any additional increase in import prices. Hence, I urge the authorities to implement expeditiously structural measures to strengthen fiscal policy, and to establish a broad-based tax system that does not adversely affect external competitiveness.

With the Fund's technical assistance, the authorities have issued a separate currency and established a two-tier banking system. At this initial stage, it is imperative to exercise caution regarding the growth of monetary and credit aggregates. It is, therefore, essential that the Bank of Lithuania effectively control the expansion of bank credit by using indirect policy instruments. In addition, I am particularly concerned by the fragile situation of the state-owned and commercial banks. Hence, I encourage the authorities to cooperate closely with the World Bank on the financial restructuring of the banking system. In this context, it is important to announce a strict cutoff date so as to reduce the moral hazard problem.

In conclusion, the authorities' strong commitment to the reform process is illustrated by their implementation, albeit with a slight delay, of a wide array of prior actions. Indeed, the implementation of a critical mass of mutually reinforcing transformation and stabilization measures should help ensure the success of the reform effort. Nevertheless, the authorities will need to build vigorously upon their initial efforts and should stand ready to implement compensatory measures, if the need arises.

With these remarks, I support the proposed decision.

Mr. Filosa made the following statement:

Notwithstanding the difficult economic situation of Lithuania, owing to a sharp worsening of its terms of trade and heavy output losses, the authorities have shown a strong resolve for reforming the economy. They have agreed quickly with the Fund on a comprehensive economic program to stabilize the economy through disciplined fiscal and monetary policies. Structural measures aimed at liberalizing the domestic economy and the external trade and payments regime are being adopted. The privatization program is already well advanced. By early 1992, price controls were removed from most products, and agricultural subsidies have been limited to amounts consistent with a balanced government budget. As proof of their determination, all prior actions have been implemented, albeit with some delay, as confirmed by the staff. Therefore, the authorities deserve strong support for their reform efforts; I approve the proposed stand-by arrangement.

We would like to commend the Lithuanian authorities for having been able to maintain budgetary discipline in the face of unfavorable economic developments, including a severe drought in the agricultural sector. The Government has also adopted specific measures to keep the budget balanced through the middle of 1993. However, the maintenance of a sound fiscal policy will require increasingly greater efforts. First, the Government faces the difficult problem of permanently widening the tax base. Its onetime effort to reduce tax collection lags might not be successful. Moreover, the other permanent structural measures that have been proposed to increase tax revenue, and to accompany the reform of the general excise tax into a full-fledged value-added tax, will take time to have an effect on tax collections.

The incomes policy in the program is presently limited to imposing a two-month freeze of government salaries beginning September 1, 1992. Subsequently, the Government announced its intention to set guidelines to restrain the rise in nominal wages to a rate consistent with the inflation target. However, with the deterioration of the economic situation expected in the winter--when the sharp increase in energy prices will heavily affect household budgets--pressures to raise wages above the guidelines will emerge. The authorities must be warned that a weak incomes policy has negative effects not only on the fiscal budget, but also on inflation developments. Previous experience in other Eastern European countries has shown that a strong incomes policy is crucial to the success of monetary stabilization. In particular, it could be difficult to ensure the enforcement of the wage guidelines set for the state sector in the emerging private sector. Therefore, the incomes policy designed by the Lithuanian authorities would need to be reinforced by an early setting of binding wage norms so as to ensure that the ability to circumvent policy measures aimed at limiting wage increases no longer exists.

In the monetary field, the authorities intend to proceed with a two-stage monetary reform entailing the issuance of coupons--the talonai--which will circulate side by side with rubles before the new currency is introduced. Overall, the authorities should be given a favorable assessment of their monetary program, as well as its implementation. This chair is satisfied with the ability of the authorities to implement the complex two-stage reform while ensuring that, in difficult circumstances, the growth of reserve money stays well within the limits established by the program. The authorities also deserve credit for having been able to comply with the recommendation of the technical assistance mission concerning the establishment of a refinancing facility as a first step toward implementing the system of indirect monetary controls. Monetary expansion is controlled by targeting the net domestic assets for both the banking system and the central bank. A laudable feature of this scheme is that the inflows derived from external financial assistance will allow greater scope for domestic credit expansion under the net domestic asset ceilings. We urge the authorities to consider that the additional credit expansion should not be used to finance the further accumulation of domestic or interstate arrears and thus perpetuate the existence of unviable enterprises. The increased credit capacity should instead be directed to financing imports of capital goods, and, more generally, to promoting the new investments that are required to materially change the productive structure of the economy.

In fact, as indicated in the medium-term outlook of the balance of payments, the reduction of the large current account could be achieved if export volumes to the convertible currency area grow at about 22 percent annually in the 1994-97 period. However, it also has to be recognized that Lithuanian exports currently specialize in consumer products and manufactures for which there is little apparent demand outside the former CMEA area. Therefore, to reduce the existing huge current account deficit to manageable proportions, a strong effort is needed to restructure and reorient the productive system in order to make it internationally competitive. Under the favorable and, perhaps, optimistic assumptions made by the staff, the debt-service payment is estimated to be quite large--on the order of 15 percent of exports to the convertible currency area. If Lithuania's exports were to grow less than the staff has estimated, balance of payments viability would not be achieved.

As this chair has repeatedly stated, the overall situation in the republics of the former Soviet Union is worthy of special consideration. The rapid and successful transition to a market economy of the Baltic states could have a significant demonstration effect on the process of economic reforms in other states of the former Soviet Union. In the expectation that the Lithuanian efforts will prove successful, we fully endorse the program.

Mr. Knight made the following statement:

Like Mr. Prader and other speakers, I regard Lithuania as an important case for the Fund and would like to make a few comments. At the pre-membership discussion on Lithuania in March, I expressed confidence, based on their history, in the ability of the Lithuanian people to deal effectively with the extraordinarily difficult problems facing them. The staff paper accompanying this request for a stand-by arrangement provides eloquent justification for that confidence, notwithstanding the magnitude of the problems ahead. Like those for Estonia and Latvia, Lithuania's program is well worthy of the Fund's support. There have been some delays, as Mr. Fridriksson's statement notes, in putting prior actions in place, but no one could reasonably interpret that as indicating a lack of commitment by the authorities.

Lithuania is currently facing the effects of an unavoidable decline in the terms of trade as energy prices are moved toward world market levels. The accompanying real income loss has been greatly added to by the continuing trade and payments problems with the CIS, with the reluctance of Russia to trade on a normal basis having been a strong negative factor. I join others in hoping that the Fund and the World Bank continue to exercise what influence they can to help restore normal trade and payments arrangements among all of the former Soviet republics, whether or not they remain technically within the ruble area.

An associated problem has been how to deal with the labor market problems associated with the large fall in production and real incomes. Here, I am pleased to note from the supplementary staff paper that real wages were adjusted downward in August and September 1992 at a rate more compatible with the needs of the situation than seemed likely earlier. It would be unfortunate to see the program put at risk by an inability to make necessary adjustments in the labor market. In this respect, the ministerial edict temporarily prohibiting enterprises from shedding labor cannot be considered helpful. However, the decision of the authorities to avoid a tax-based enforcement mechanism for wages policy was probably wise, given the paramount importance of public support for achieving the miracles of adjustment that remain ahead.

Monetary policy has so far been hampered by a curious mix of problems: first, a shortage of ruble notes; and, later, an unwelcome large inflow from neighboring states as the Moscow printing presses apparently went into overdrive. The authorities appear to have dealt with these divergent phenomena in an effective way so far, but the real pressures on monetary policy--as elsewhere--lie in the future. Some necessary and sensible initial steps have been taken, but further strengthening of the institutional base is essential if an effective monetary policy is to emerge.

Much depends on the firmness with which fiscal discipline can be sustained. Here, as in other key policy areas, the commitment of the authorities seems undoubted. There is no real alternative to a tight rein on government expenditure and continuing efforts to strengthen revenue. Given that there is no present market for the issuance of government paper, the risk of fiscal slippage translating quickly into higher inflation rates is very real.

The staff modestly remarks in its appraisal on page 27 that "projections of the external current account are highly uncertain," a comment that my old English teacher would have described as a "masterpiece of meiosis," or understatement. It is easy to agree, however, that Lithuania will have a clear need for exceptional financing in the year immediately ahead, whatever may be achieved via the many elements of the adjustment program. This gives emphasis to the importance of encouraging foreign direct investment in Lithuanian enterprises.

I will end by commending the staff on the exceptional efforts that it has made to work constructively with a country that seems determined to remake its future. I join others here in hoping very sincerely that the efforts of the Lithuanian authorities and people are suitably rewarded.

Ms. Duan made the following statement:

We welcome Lithuania's request for a stand-by arrangement. The courage and speed with which the authorities have proceeded with economic transformation and reform following independence are very impressive. As shown in the staff paper and the authorities' memorandum of economic policies, priorities in stabilizing and transforming the economy have been well identified, and policies have been formulated to achieve goals in major areas. Over the past year, remarkable efforts have been taken to spur the emergence of a private sector. Sales of businesses and dwellings have been conducted on a large scale and facilitated by the creation of "special investment accounts." Price liberalization has also advanced quickly as price controls for most products were removed by early 1992. Meanwhile, the authorities have also moved ahead with building an institutional infrastructure that accommodates a market-oriented economy.

However, the authorities' endeavor to break away from the old economic structure has been complicated by continuously falling economic activities, the disruption of trade with the former Soviet Union, and the sharp deterioration in the terms of trade.

The difficulties that the authorities face in transforming the economy and meeting the challenges of the emerging system are enormous. Despite this, they have demonstrated a strong commitment not only through their achievements so far, but also through the comprehensive economic stabilization and reform program recently formulated in cooperation with the Fund. We are pleased to learn from the supplement to the staff paper that all the prior actions of the program have now been met. And, as Mr. Fridriksson indicates in his opening statement, this has been accomplished in a very difficult environment. We believe that the authorities' commitment and endeavors warrant the support of the international community, and, therefore, we support their request for a stand-by arrangement with the Fund.

Meanwhile, we would like to emphasize that the program's success hinges on the authorities' strong commitment to both stabilization and structural policies which is crucial in view of the difficult period ahead. An effective incomes policy to restrain wages in adjusting to the terms of trade shock is crucial to contain further losses in the economy and the income of the country as a whole. The second stage of the incomes policy, which adopts forward-looking wage guidelines based on the program target for inflation, is also commendable. We believe that the successful implementation of this two-stage incomes policy will make an important contribution toward reining in one of the most potentially destabilizing factors during this critical period, and toward ensuring the success of the overall stabilization effort.

Given the severe constraints that Lithuania is facing in energy supply, especially oil and gas, another aspect critical to the authorities' economic program is an early agreement with Russia and the other CIS republics on various trade and settlements issues. Committed efforts in this area would go a long way toward helping to arrest the fall in output and economic activities in general.

Having said this, we also welcome the important measures taken by the authorities to maintain a disciplined fiscal policy, and to proceed further with tax, financial sector, and other structural reforms in support of the economic program.

The staff representative from the European II Department noted that the budgetary estimates provided for what might be called a contingency reserve of about 1/2 of 1 percent of GDP. Otherwise, the authorities were committed to balancing the 1993 budget, which would be shortly be presented to Parliament for ratification. If action had to be taken quickly on the revenue side, the authorities could either raise the excise taxes or improve the value-added tax. Preparations were already under way to make the latter tax more comparable to those used in other European countries. On the expenditure side, it was expected that the review of the social security system, which was being conducted with the cooperation of the World Bank, would be concluded by the end of 1992--which was also the end of the fiscal year.

The deterioration in Lithuania's terms of trade in the first half of 1992--almost 15 percent of GDP--had been more significant than any widening of its financing gap, the staff representative considered. That figure was comparable to the terms of trade shock experienced by Estonia over the same period, and slightly smaller than Latvia's, which had no domestic energy sources.

The staff estimated that, in order to adjust for the terms of trade shock, real wages should fall by about 45 percent by the end of 1992, the staff representative continued. As was indicated in the table in Annex VI, the decline in real wages had begun with the 16 percent drop recorded in July 1992. Since then, real monthly wages had declined by 7 percent in August 1992, and, if early indications were correct, the fall had accelerated in September 1992. If the incomes policy worked as expected, it would be possible for the authorities to achieve or even exceed the needed cut in real wages by as early as October 1992.

Because the current wage freeze was not intended to be a permanent measure, the risk that wage differentials would be frozen at incorrect levels was not a major cause for concern, the staff representative commented. Moreover, under the forward-looking, inflation-based guidelines that would take effect in November 1992, wage differentials within enterprises would be set by the managers of those firms. It should also be noted that the Government's incomes policy applied only to the government and state enterprise sectors; nevertheless, the staff and the authorities hoped that the envisaged guidelines would have some impact on settlements in the private sector as well.

Foreign investment had just begun to flow into Lithuania, the staff representative observed. So far, the service and manufacturing sectors had been the main beneficiaries. As was mentioned in the staff paper, foreign participation in the privatization of state enterprises was also being considered.

Even before the talonas had replaced the ruble, the trade and payments system had not been working well, the staff representative remarked. Not surprisingly, the introduction of the new currency had further complicated that system's operation. The Lithuanian authorities were attempting to reach agreement with CIS representatives on settlement mechanisms. In that connection, Lithuania's decision not to accept the share of debt assigned to it in the agreement reached by other former republics of the Soviet Union should not be given too much emphasis; other factors were more relevant to the payments and settlement discussions.

As was mentioned in the paper, the authorities had indicated their willingness to discuss the servicing of the $35.7 million in debts incurred by Lithuanian enterprises through Vneshekonombank, the staff representative from the European II Department added. Negotiations were under way with creditors on part of that debt. Otherwise, debt issues had not featured greatly in recent discussions with other republics of the former Soviet Union.

The Director of the Policy Development and Review Department said that the payments and settlement system used by the republics of the former Soviet Union posed an extremely serious problem. In that connection, the staff was attempting to learn more about the intent behind the agreement reached at Bishkek by CIS members, to which the Managing Director had referred at the beginning of the meeting. At present, not much was known about either the form or function of the interstate bank discussed in the agreement. However, the agreement had mandated the formation of a working group, which was to issue a report on the proposed interstate bank by December 1, 1992. Although that group's terms of reference were not clear, its report might well provide the basis for establishing a cooperative forum, through which the staff could work more closely than had been possible before on payments and settlement problems.

Beyond that, the Director continued, a work program was under way to identify the specific technical areas where quick, straightforward improvements in the payments and settlement system could be made. For instance, more use could be made of telecommunications--and less of the postal system--in the clearing process; large-value transaction systems could be set up so that the most important transactions could go through the system quickly; and payments could be made directly via the commercial banks rather than through the central banks.

Much would depend on the willingness of the parties to work together, the Director observed. Fortunately, there seemed to be a growing awareness that the establishment of an efficient payments and settlement system was a precondition for any revival of trade among the republics. Accordingly, the opportunity for setting up such a system was greater at present than it had been in the past six to nine months.

With respect to the delayed circulation of the supplement to the staff paper, the Director recalled that, on September 30, 1992, when the paper in which a supplement had been promised had been issued, it had not been envisaged that its preparation would require a follow-up mission to Vilnius. However, the complications that had followed the introduction of the talonas, as well as other problems relating to the prior actions, had made it clear that further discussions with the authorities would be necessary. In planning the follow-up mission, the staff had been constrained, on the one hand, by its obligation to provide the Board with the promised supplementary information as quickly as possible, and, on the other, by the need to give the authorities sufficient time to prepare a description of the prior actions that they had implemented.

The staff had returned from Lithuania on the night of Thursday, October 15, 1992 and had provided him with a draft of the supplement on the evening of Friday, October 16, 1992, the Director of the Policy Development and Review Department stated. He had returned his comments on the morning of Monday, October 19, 1992, thereby delaying its issuance until Tuesday, October 20, 1992.

Mr. Fridriksson made the following concluding remarks:

The staff has dealt fully with the questions and issues raised by Directors, and I will add only a few comments. At the outset, I would like to thank Directors for the keen interest that they have shown in the Lithuanian program, and for their constructive comments. Their views will be duly reported to my authorities in Vilnius. I will also convey to my authorities the concerns that have been expressed, notably by Mr. Esdar, on the delays in the implementation of some of the prior actions.

In this respect, I would like to emphasize that administrative efficiency, or what Mr. Esdar referred to as implementation capacity, is not yet what we may be used to in most other countries--not least because many of the concepts and methods that most of us have grown up with are completely foreign to those who have lived in a command economy, and the time for training and building up expertise has been quite limited so far. The Lithuanians are off to a good start, and they have every intention of quickly acquiring the various skills for operating a market economy.

As noted, Lithuania has taken an important step toward adopting its national currency, the litas, by separating its interim currency from the ruble area. It was important for economic reasons to depart from the ruble area, but I might add that an opinion poll conducted in late summer 1992 showed that the number one priority issue for most Lithuanians was the introduction of the litas, with Russian troop withdrawal coming in second.

The implementation of the program will not be easy, as has been noted, and pressures on the budget will undoubtedly emerge during the winter. I should re-emphasize, however, that the Lithuanian authorities are fully committed to the implementation of the program. Senior officials in the most important ministries and the Bank of Lithuania have the memorandum of economic policies on their desks for quick reference at all times.

As I mentioned in my opening statement, the external financing of the program is virtually assured. I would also like to mention the reluctance of the authorities to incur external debt, except in relation to profitable investment. With reference to

Mr. Shimuzu's comments, Lithuania intends to create a very liberal environment for foreign direct investment.

As noted by several speakers, the external environment is very difficult in many respects, and it is of the utmost importance for Lithuania, as well as other countries in similar circumstances, to re-establish the trade relations that prevailed for decades. Otherwise, the contraction of output will be much sharper and the adjustment and reform efforts correspondingly more difficult. Needless to say, the actions of Russia are of overriding importance. As has been noted, Lithuania is currently subjected to energy prices above world market levels and has to prepay for deliveries of oil and gas from Russia. I fully agree with the comments made by Mr. Posthumus on this issue, and I am sure that we will be able to deliver our message forcefully to the Russians soon after they join the Executive Board.

This is the third Baltic stand-by arrangement to come before the Board in the course of five weeks or so. As a general remark--and one not specifically related to Lithuania--I would like to restate what the Board has noted, namely, that the authorities in these three countries have shown great determination in putting together strong and comprehensive stabilization and structural programs that warrant the full support of the Fund and the international community. However, I would like to strongly underscore what Mr. Dawson mentioned in his statement, namely, that we are dealing with countries where the statistical base and data availability are still poor, and where most economic institutions are in their infancy. Moreover, as I mentioned earlier, many of the concepts and aspects of the workings of a market economy are new to the authorities. As a result, we may encounter unforeseen difficulties in the early stages of the programs. When, and if, they arise, the most important priority will be to maintain the momentum of the adjustment and reform effort intact--to keep the broad policy objectives in place--even if performance criteria might have to be slightly modified from time to time. These comments should not at all be taken to mean that I am expecting slippages in these programs. The commitment and aspirations of the authorities are strong and have been convincingly demonstrated to the world.

In this respect, I would like to quote the last paragraph of the Chairman's concluding remarks at the seminar on the experience with programs in Eastern Europe and the reform strategy in the former Soviet Union (Executive Board Seminars 92/2 and 92/3, 9/9/92):

> Directors agreed that the Fund's approach in the republics of the former Soviet Union needed to allow for a high degree of adaptation--both in assessing current

> developments and in projecting the outcome of reforms--on the basis of new and ongoing learning, while ensuring that the reform process continued. In such conditions, imagination was needed in setting program objectives, and the Fund must remain ready to alter its policy recommendations to take into account the evolving experience.

Needless to say, I agree with this.

Table 14 in the paper before us today lists 11 Fund technical assistance missions to Lithuania since December 1991--and to this list we may add two technical assistance visits from the Treasurer's Department, as well as the establishment of a resident representative post in the spring of 1992. This assistance has been of crucial importance, but much more is needed in the months ahead, not least in the area of central banking and monetary policy operations. We might have to consider the placement of technical assistants in the central bank--and Ministry of Finance, for that matter--for a few weeks or months at a time. In this whole endeavor, it is very important to coordinate the technical assistance being provided, for example, by the Fund and various central banks; resident experts posted to central banks without consultation or coordination with the Fund may not necessarily be very helpful. If inadequate or insufficient technical assistance is made available in fundamental areas, then the chances of successful adjustment and reform will be greatly reduced.

I visited Vilnius last week. The temperature was near freezing, and the heating season had not begun. When I was at school in Iceland, we used to think that cool temperatures stimulated the mind. Cold houses and workplaces are uncomfortable, to say the least, but perhaps one may hope that the cold invigorates the thinking and activity of the Lithuanians. They are committed to radical change, and their motto might very well be: "Economic pain deferred is rarely pain diminished."

In closing, I would like to thank the Managing Director for the very important role that he played during his visit to Lithuania in August 1992 in contributing to the arrangement that we have before us today. I would also like to thank the mission chief and other members of the staff for the excellent cooperation that I and my office have enjoyed with them on the Lithuanian program.

The Chairman said that he was led by those remarks to thank Mr. Fridriksson for his own contribution to the negotiation of the programs, and for his tireless efforts in bringing them to fruition, which he felt certain would continue.

The Executive Board then took the following decision:

1. The Government of Lithuania has requested a stand-by arrangement for a period of 11 months in an amount equivalent to SDR 56.925 Million.

2. The Fund approves the stand-by arrangement set forth in EBS/92/157, Supplement 1.

Decision No. 10167-(92/127), adopted
October 21, 1992

4. NINTH GENERAL REVIEW OF QUOTAS AND THIRD AMENDMENT

Mr. Dawson said that, in response to various inquiries that he had received from staff members and Executive Directors, he wished to inform the Executive Board that the U.S. Congress had passed the appropriate legislation authorizing the increase in the quota of the United States. The appropriations bill itself had been signed by the President. The authorization bill, which was also necessary and was the vehicle containing the Third Amendment, had arrived at the White House and would be signed within the next week. One or two other remaining steps could probably be taken simultaneously with the signing, which should make it possible for the necessary consent to the quota increase as well as acceptance of the Third Amendment to the Articles of Agreement to be provided to the Fund by November 1, 1992.

The Chairman thanked Mr. Dawson for the good news.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/126 (10/14/92) and EBM/92/127 (10/21/92).

5. ARTICLE IV CONSULTATION CYCLES - REVIEW OF TEMPORARY CHANGES

The Executive Board has reviewed the temporary shift in consultation cycles as provided for in the statement of the Chairman at EBM/91/157 (11/22/91) and decides that, effective November 22, 1992, consultations with members shall be held in accordance with Appendix I of EBD/92/240 (10/9/92).

Decision No. 10168-(92/127), adopted
October 15, 1992

6. REPUBLIC OF BELARUS - REPRESENTATIVE RATE FOR RUSSIAN RUBLE AS CURRENCY OF BELARUS

The Fund finds, after consultation with the authorities of the Republic of Belarus, that the representative rate under Rule O-2(b)(i) for the Russian ruble (as currency of Belarus) against the U.S. dollar is the midpoint between buying and selling rates for the Russian ruble against the U.S. dollar in the interbank market, as ascertained by the Central Bank of Russia. (EBD/92/243, 10/9/92)

Decision No. 10169-(92/127), adopted
October 14, 1992

7. ADMINISTRATIVE TRIBUNAL - ESTABLISHMENT - REPORT TO BOARD OF GOVERNORS AND RESOLUTION

The Executive Board approves the submission of documentation set forth in EBAP/92/147 (10/9/92) on the establishment of an Administrative Tribunal for the Fund.

Adopted October 15, 1992

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAM/92/96 (10/14/92) and EBAM/92/97 (10/15/92) and by Assistants to Executive Directors as set forth in EBAM/92/98 (10/15/92) is approved.

9. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/92/150 (10/16/92) is approved.

APPROVED: April 23, 1993

LEO VAN HOUTVEN
Secretary