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Statement by the Staff Representative on the Republic of Lithuania
Executive Board Meeting
August 7, 2009

1. This statement reports on key data releases and measures undertaken by the authorities since the staff report (SM/09/203, 7/24/09) was issued. The new information does not alter the thrust of the staff appraisal.

Policy developments

2. **Parliament adopted a second revision to the 2009 budget on July 23**. The package comprises (i) on the tax side, an increase in the standard VAT rate from 19 to 21 percent effective September 1, an increase in the VAT rate for heating from 5 percent to 9 percent (albeit less than previously planned), and a decrease in diesel excise taxes; and, (ii) on the expenditure side, a cut of 5 percent cut in the basic wage of civil servants combined with progressive cuts in wage scale coefficients and bonuses, as well as a 8 percent reduction in teachers, police, and health workers' wages reflecting similar changes to that implemented for civil servants, with changes for both categories of worker effective through end-2010. A 10 percent cut in maternity and paternity benefits was also approved but subsequently vetoed by the President of the Republic given concerns about its implications on existing benefit recipients, although the reduction in the maternity allowance replacement rate for new recipients to 90 percent for the first year, and 75 percent for the second year from July 2010 onwards was cleared. As measures are being implemented later than previously expected and the yield from some is smaller than anticipated, the authorities' have reduced their estimate of the net savings from the package from the 0.7 percent of GDP noted in the staff report to 0.4 percent of GDP in 2009 (and from 1.7 to 1.2 percent of GDP annualized). On the basis of the GDP forecasts presented in the staff report, these savings would place the fiscal deficit in the range of about 9½ percent of GDP in 2009.

3. **Parliament also adopted the Financial Stability Law and an amended Deposit Insurance Law**. The former further strengthens the capacity of the government to speedily address potential problem banks, should the need arise, by providing the government the power to intervene a bank. However, due to constraints in Lithuania's legal framework, the new Financial Stability Law does not provide for more flexible alternatives such as the purchase and assumption of problem banks. A working group comprising government and Bank of Lithuania representatives has been created to facilitate the rapid formulation of the implementing regulations for this law. In addition, the law on deposit insurance was amended to render permanent the increase in deposit insurance up to €100 000—consistent with EU directives— and to shorten the compensation period for payments to depositors to a maximum of 20 business days from the day of the insured event.

Recent macroeconomic indicators

4. **Provisional flash GDP estimates for the second quarter revealed a deeper-than-expected contraction in economic activity.** For the second quarter, the flash estimate of headline GDP growth was assessed by Statistics Lithuania at -22.4 percent (y/y), a substantially higher contraction than anticipated by consensus and staff forecasts (the latter at -15.5 percent), while revisions to the first quarter GDP data were relatively minor.

5. **The flash GDP estimate underscores the downside risks to the forecasts in the staff report**. The depth of the decline in GDP was sharper than suggested by certain higher-frequency indicators which had which signaled a tentative stabilization of activity, albeit at a very weak level. Seasonally adjusted, industrial production had begun to move upwards on a month-on-month basis during the second quarter, and the same for retail sales on a year-on-year basis. Given the uncertainty surrounding the flash estimates—including the large role played by statistical discrepancies in driving the first quarter GDP outturn—and the fact that the components of GDP will only be available end-August, the growth projection presented in the staff report remains staff's most recent estimate. However, should the GDP flash estimates be confirmed, staff would reappraise its GDP growth forecast to be in the range of -20 percent for 2009, with a preliminary assessment suggesting a worsening in the general government deficit of at least of 1.0 percent of GDP for 2009 to around 10½ percent of GDP (9.1 percent of GDP in the staff report) and an increase in the 2010 financing need of about 1¾ percent of GDP.

6. **Recent monetary data point to continued tightening in monetary conditions while the recent eurobond issue helped boost international reserves.** End-June data show reserve money contracted by 14¾ percent (y/y) and broad money by 7.6 percent (y/y). By end-June 2009, international reserves stood at €4.45 billion, showing an improvement relative to end-May (€4.2 billion) and reflecting the impact of the €500 million eurobond issue.

7. **Reflecting the ongoing credit contraction, private sector credit growth decelerated to 1.5 percent year-on-year in June, from 17.8 percent as of end-2008.** Over the six months since December, credit to the private sector has decreased by 4.1 percent. The adjustment has been particularly sharp in household credit, with new loans extended falling by 55 percent (y/y). The share of foreign currency denominated loans and deposits has risen to 68 and 31.9 percent, respectively.

8. **Preliminary data show the half year central government deficit measured on a cash basis widened to 5.3 percent of staff's full-year GDP estimate, as the decline in revenue outpaced spending.** Tax revenues were down about 29 percent (y/y). Although spending in the first half was up by about 10 percent (y/y) in nominal terms relative to the same period in 2008, this in part reflects higher interest outlays, and base effects. Relative to the second half of 2008, spending excluding interest was down over 3 percent in nominal terms.