FOR AGENDA

EBS/93/86
Supplement 1

CONFIDENTIAL

June 24, 1993

To: Members of the Executive Board

From: The Secretary

Subject: Lithuania - Review Under the Stand-By Arrangement

The attached supplement to the staff report for the second review under the stand-by arrangement for Lithuania (EBS/93/86, 6/7/93) has been prepared on the basis of additional information.

Mr. Knöbl (ext. 38821) or Mr. Wein (ext. 38794) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

LITHUANIA

Second Review Under the Stand-By Arrangement
Recent Developments--Supplementary Information

Prepared by the European II and
Policy Development and Review Departments

Approved by John Odling-Smee and Anoop Singh

June 24, 1993

I. Introduction

The actions taken by the authorities in April and May to stabilize the exchange rate of the talonas and bring down the rate of inflation have begun to yield results. The exchange rate has appreciated sharply against the U.S. dollar and inflation appears to be dropping quickly. In view of the improved macroeconomic climate, the authorities have announced that the second stage of their currency reform, which entails the replacement of the talonas by the litas as the national currency, would begin June 25, 1993.

II. Monetary and Exchange Rate Developments

As of June 21, the exchange rate of the talonas had appreciated by almost 40 percent against the U.S. dollar from its lows in early May (see Chart 1). Commercial banks, which had maintained large open foreign exchange positions before the new round of monetary tightening began, were reported to have cleared their positions. As the talonas has appreciated, demand for foreign currency has dropped sharply.

At the same time, monthly inflation dropped from 25 percent in April to 12.7 percent in May, with signs of further declines. The increase in the bi-weekly price index for food products, which was 9.7 percent in the two weeks ending April 22, has fallen steadily, and was only 1.4 percent in the two weeks ending June 7. Wage increases have also been moderate, with the average wage in the economy increasing by only 7.3 percent in May.

Since the increase in reserve requirements took full effect in early May, monetary conditions have remained tight. The Bank of Lithuania has continued to auction reserve money to allow banks to meet required reserves, but interest rates at these auctions have been consistently above 150 percent, compared with a previous interbank rate of some 80 percent.

The authorities have continued to improve the system of monetary control, and to respond promptly to emerging technical problems. Having achieved the short-term goal of tightening policy to support the exchange rate, the Bank of Lithuania is moving to rationalize the required reserve regulations. Banks will soon be allowed to hold part of their required reserves against foreign currency deposits in foreign currency; stiff penalties for reserve deficiencies are being consistently levied; and the grace period for covering overdrafts at the central bank, introduced to give banks added flexibility in reserve management, has been phased out.

The introduction of the litas was announced by the Governor of the Bank of Lithuania on June 17. The temporary currency, the talonas, will be phased out over a period of 25 days, starting on June 25 and ending on July 20. There will be one uniform conversion rate of 1 litas per 100 talonai. From July 20, the litas will be the only legal tender in Lithuania. Merchants, however, may continue to conduct business in foreign currency until August 1. As previously announced, foreign currency deposits, at home and abroad, will not be affected by the currency reform. The domestic reaction to the currency reform has been positive, with the exchange rate of the talonas continuing to appreciate following the announcement. The surrender requirement for foreign exchange earnings of state enterprises will be abolished before the end of June.

The authorities are considering ways to provide compensation to small depositors at the Savings Bank to offset the effects of past inflation. Care would need to be taken that such compensation does not strain the budget and undermine the significant progress toward monetary stability that the authorities have so recently achieved.

III. Real Economy and Structural Reform

There is now evidence that economic activity is stabilizing, with continuing declines in the state sector offset by growth in private sector activity, particularly services. The recovery also continues to be constrained by a lack of external import financing.

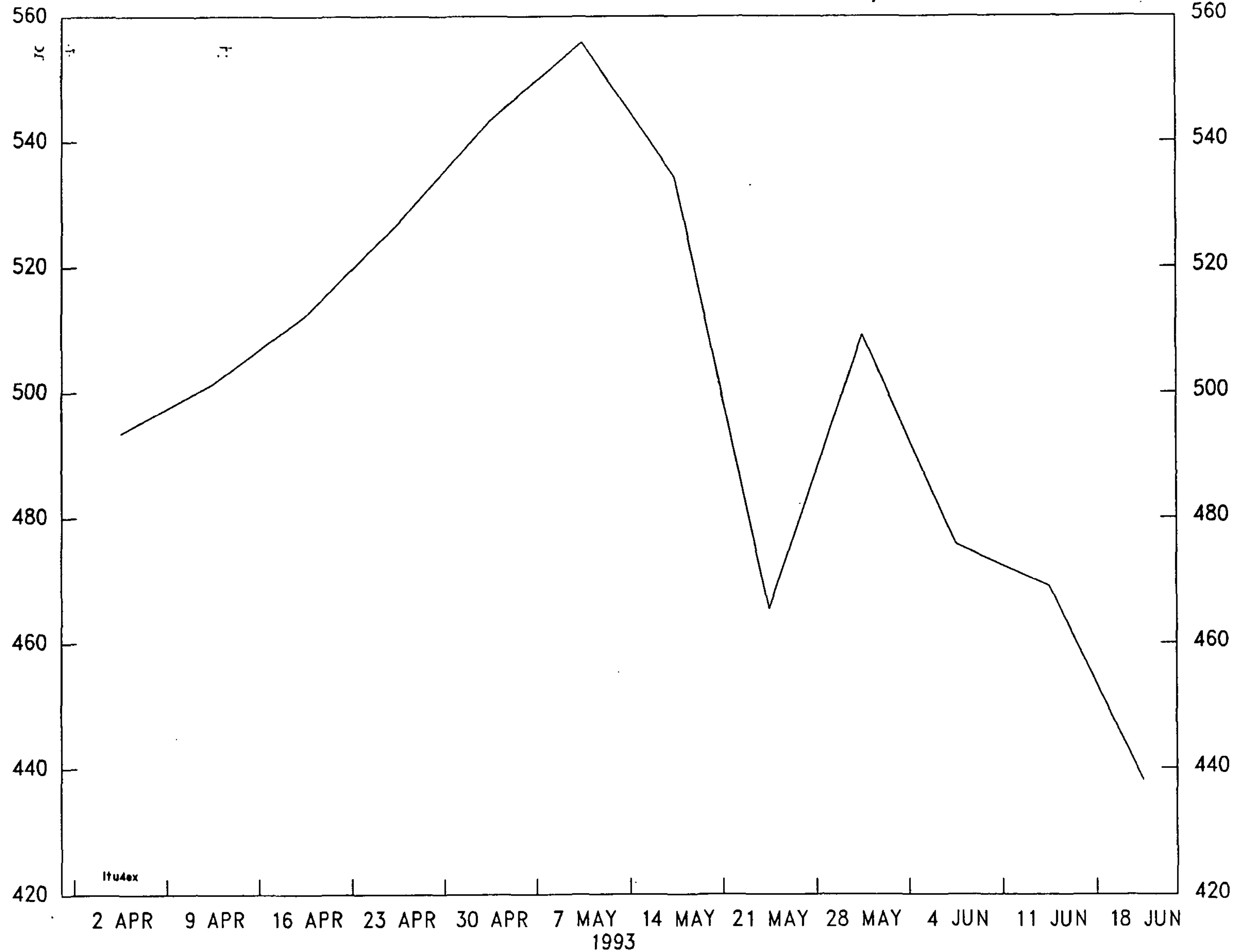
With the modest increase in wages during May, real wages declined still further, yielding an aggregate decline of 63 percent from the post-price reform high set in June 1992.

The Government has adopted a new trade system which will become effective July 15, 1993. While the new trade regime departs from the announced intention of introducing a uniform tariff rate of 10 percent, the vast majority of goods may be imported at one of three rates between 5 and 15 percent (and many goods enter tariff-free). The main exceptions are sugar, butter, eggs and oil (which have tariff rates of 20-30 percent); alcohol, tobacco, and precious metals (up to 100 percent); and about a dozen categories of manufactured goods, some of which are quite narrow, carry tariff rates of 20 or 25 percent. The trade reform also provides for the

CHART 1

LITHUANIA

EXCHANGE RATE AGAINST THE DOLLAR 1/



Source: Bank of Lithuania.

1/ Weekly average, mid-rate, weighted average for all banks.

removal of quantitative restrictions on exports, with their replacement by tariffs for some formerly restricted goods. However, the export of most foodstuffs and some agricultural inputs will remain prohibited until October 1, 1993.

The Government has transmitted a proposal for a value-added tax to Parliament. However, it is not now likely to be discussed by the Parliament before the summer recess.

IV. Staff Appraisal

The authorities' renewed efforts at macroeconomic stabilization have begun to show results. The outturn for May 1993 and the initial indications for June have been consistent with the revised objectives of the program and auger well for the future. The staff is, however, concerned that full compensation of Savings Bank depositors for the effects of inflation could endanger the budget and the still fragile stabilization gains. The staff therefore urges the authorities to proceed with utmost restraint in the adoption of any such proposal.

The staff welcomes the more liberal trade regime that has been adopted after repeated delays, although it is in some respects more complex and restrictive than previously anticipated. The staff urges the authorities to keep the new structure closely under review and move over time to a more uniform structure with a minimum of tariff bands.