FOR AGENDA

EBS/92/157

CONFIDENTIAL

September 30, 1992

To: Members of the Executive Board

From: The Secretary

Subject: Lithuania - Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on Lithuania's request for a stand-by arrangement in an amount equivalent to SDR 56.925 million, which is proposed for discussion on Wednesday, October 21, 1992. A draft decision appears on page 29.

Mr. Knöbl (ext. 38821), Mr. Isard (ext. 36640), or Mr. Wein (ext. 38794) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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Department Heads

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INTERNATIONAL MONETARY FUND

LITHUANIA

Request for Stand-by Arrangement

Prepared by the European II Department
and the Policy Development and Review Department

(In consultation with other Departments)

Approved by John Odling-Smee and Jack Boorman

September 29, 1992

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I. Introduction

In the attached letter to the Managing Director, dated September 21, 1992, along with the accompanying Memorandum of Economic Policies and a supplementary letter dated September 26, 1992, the Lithuanian authorities request an 11-month stand-by arrangement in an amount equivalent to SDR 56.925 million in support of a program for the period of July 1, 1992 through June 30, 1993. If approved by the Executive Board, the arrangement will provide for four purchases: the first one of SDR 17.25 million (25 percent of quota) upon Executive Board approval of the arrangement; and three subsequent purchases of SDR 13.225 million each (19.17 percent of quota each) upon observance of the conditions described in Section V for the test dates December 31, 1992, March 31, 1993, and June 30, 1993. Assuming that all purchases under the arrangement are made as scheduled, total use of Fund credit by the end of the arrangement would amount to 82.5 percent of quota 1/ (Tables 11, 12 and 13).

Lithuania became a member of the Fund on April 29, 1992. 2/ Program discussions with the Lithuanian authorities were conducted during three missions to Vilnius from April 20 - May 4, 1992, June 18 - July 3, 1992, and August 24 - September 4, 1992. 3/ These discussions began soon after the Executive Board had met to consider the Pre-Membership Economic Review 4/ on March 31, 1992. 5/ At that meeting, Directors commended the Lithuanian

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1/ Equivalent to annual access of 90 percent of quota.

2/ See Appendix I.

3/ Previously, an acquaintance mission from the Fund had visited Vilnius during the period November 18-29, 1991, followed by a membership mission from January 31 - February 13, 1992. Staff members who participated in all or most of the five missions were Mr. Knöbl (Head), Mr. Ikeno (EP) and Mr.Wein, all EUR II, Mr. Hides (STA), Mr. Isard (RES), Ms. McGuirk (PDR), and Mr. Thai (FAD). Mr. Francotte (LEG) and Mr. Franklin (SEC) participated in both the acquaintance and membership missions, Mr. Burton (PDR) and Mr. Tavlas (TRE) in the acquaintance mission, Mr. O'Callaghan (for TRE) in the membership mission, and Mr. Cornelius (PDR) in the fifth mission. The administrative assistants were Ms. Strayer (EUR II), Ms. Orpin (WHD), Ms. Rome (EUR II), Ms. Myers (ADM), and Ms. Metzger (EXR).

4/ SM/92/60 (3/13/92), "Lithuania: Pre-Membership Economic Review". Article IV consultations have not yet been held with Lithuania.

5/ The program discussions were assisted by the resident representative, Mr. Hedfors, who participated from the EUR II Department in the first three missions before taking his post in Vilnius in late May 1992; by Mr. Fridriksson's participation in part of the June/July mission; and by the Managing Director's visit to Vilnius from August 19-22, 1992. Despite a change in Government on July 21, 1992, when Aleksandras Abisala was elected to replace Gediminas Vagnorius as Prime Minister, the discussions maintained continuity.

authorities for their commitment to the decentralization of economic decision-making and the creation of an emerging private sector. They encouraged the authorities to persevere with the economic transformation despite the sharp decline in economic activity caused by trade disruptions, but noted that even if trade disruptions were overcome, Lithuania would have to adjust to a large adverse shift in its external terms of trade. They recommended that Lithuania should not introduce a separate currency without adequate preparation to exercise financial control, noted the importance of maintaining a disciplined budget and introducing a transitional incomes policy, and urged the Lithuanian authorities to sustain the momentum of structural reforms.

Simultaneously with assisting the Lithuanian authorities to develop a program of economic policies that could qualify for financial support from the international community, the Fund has sent nearly a dozen technical assistance missions to Vilnius during the past ten months. 1/ These missions sought to help strengthen the institutional and statistical framework necessary for the conduct of effective stabilization policies, and to prepare for the time, now imminent, when Lithuania would have its own currency and the ruble would cease to be legal tender. A series of missions from the World Bank have also visited Lithuania since January 1992 to lay the groundwork for World Bank membership and a broad program of lending and economic and sector work, 2/ including an import rehabilitation loan that has been under negotiation in parallel with the discussions on an arrangement from the Fund. Through close consultation between the Fund and World Bank staffs, the two sets of discussions have led to mutually consistent stabilization and structural policies.

II. Recent Developments

Although Lithuania did not achieve international recognition of its independence until August 1991, a renewed struggle to secede from the former Soviet Union (FSU), and to transform the Lithuanian economy, began in March 1990 following the election of a Supreme Council (Parliament) with a non-Communist majority. The effort to transform the Lithuanian economy, and to establish macroeconomic stability, has met with great difficulty. Some of the difficulty resulted from Lithuania's continuing reliance on the ruble as a medium of exchange pending institutional reforms to lay the groundwork for the successful introduction of its own currency. Much of the difficulty, however, has been associated with the structure of production inherited from the Soviet regime. In the past, many enterprises depended heavily on other states of the FSU as sources of inputs and markets for output, and their viability was based on terms of trade that were distorted in favor of Lithuania under the Soviet price system. This has left Lithuania vulnerable to disruptions of trade with the FSU, particularly

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1/ See Appendix II.
2/ See Appendix III.

because it has no significant domestic sources of primary energy products and is constrained by existing pipeline and harbor facilities to rely predominantly on Russia as a source of oil and gas. It has also left Lithuania to face a very harsh terms-of-trade shock.

In this setting, recent economic developments in Lithuania have been shaped to a major extent by the instability of the ruble and difficulties with the ruble payments system, by temporary disruptions of trade with the states of the FSU in the summer of 1990 and the first two months of 1992, and by the adverse shift in the terms of trade as the prices of oil and other traded goods have moved to world market levels. The average cost of Russian oil delivered to Lithuania was still less than half the world market price in June 1992 and rose sharply to around the full world market level by the beginning of September. Accordingly, much of the adjustment to the terms of trade shock is still in process.

1. Price liberalization and privatization

The Lithuanian authorities began to move forward with price liberalization and privatization well before the start of policy discussions with the Fund staff. The legal framework for the removal of price controls was spelled out by a law on prices drafted in July 1990, and the process of price liberalization proceeded in stages, beginning effectively in early 1991. By early 1992, price controls had been removed from most products. The only goods and services still subject to price controls as of September 1, 1992 were energy products and a small number of other goods and services (primarily rents and other municipal services, utility services, communications, transportation, and some alcoholic beverages and tobacco products) for which price controls were justified on the basis of monopolistic conditions or social considerations. Although the prices of energy products remain controlled, prices to final users have been adjusted in stages, in parallel with the rising prices of primary energy imports, to cover the overall costs of imports, production, and distribution. There are no minimum support prices in agriculture, and agricultural subsidies (which are responsive to a severe drought during the current year) have been limited to amounts that could be accommodated within a balanced general government budget.

In addition to moving ahead with price liberalization, the Lithuanian authorities have attached high priority to the rapid creation of an effective private sector. The privatization program has aimed to provide property to Lithuanian citizens through sales involving a combination of cash and vouchers. Vouchers were distributed to citizens in February 1991, in amounts based on age, and in the form of "special investment accounts" at the Savings Bank. The first privatization sales began in September 1991, the month after Lithuania's independence was recognized internationally. By mid-1992, nearly 80 percent of small businesses had been privatized through auctions, and by mid-August, more than 75 percent of state-owned flats had been sold. The privatization of small businesses and dwellings is expected to be completed no later than the end of 1992.

The privatization of large state-owned enterprises 1/ through public offering of shares is also well under way and expected to be completed by the end of 1993. By mid-1992, about 600 of the 1100 large enterprises included in the first phase of the program had, on average, nearly 70 percent of their shares in private hands. Nevertheless, for some of the larger enterprises, the demand for shares has been weak. As noted below, a number of new privatization initiatives are being launched to address this problem.

The Lithuanian authorities have also been moving forward with the process of privatizing land and other assets of the agricultural sector. They anticipate that, by the end of 1992, 50 percent of all usable land will be privately owned and 80 percent of the total assets from collective farms and state farms will become private property. Most restrictions on the sale and resale of nonagricultural land have been removed, with the expectation that the remaining restrictions on land sales will be eliminated by mid-1993.

2. Fiscal developments

The Lithuanian authorities maintained a disciplined fiscal policy during 1991 and the first half of 1992 (Tables 1 and 6). In terms of the general government budget, 2/ the outturn for 1991 was a surplus of about 3 percent of GDP. This surplus reflected a reduction in subsidies along with the positive effects on tax revenues of a favorable (but temporary) shift in the external terms of trade.

The general government budget remained in surplus during the first quarter of 1992, but the fiscal situation has become much more difficult with the continuing decline in real output (Tables 1 and 2) and the rise in prices of imported energy products. The strain on the fiscal position became evident in the second quarter with the emergence of a small deficit.

3. Monetary developments and the banking system

In preparation for the introduction of Lithuania's own currency, the Bank of Lithuania (BOL) has undertaken a number of institutional changes necessary to conduct monetary policy appropriately after the ruble ceases to be legal tender. The banking system has been reorganized into a genuine two-tier structure. With the recent decision to separate the BOL into a central bank retaining the same name, and the State Commercial Bank of Lithuania, the second tier of the banking system comprises three large

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1/ The distinction between "large" and "small" enterprises is based on a book-value measure of capital ("authorized capital").

2/ The general government budget is the consolidated budget of the state and local governments and all extra-budgetary funds, including the Social Insurance Fund, the Government's foreign currency funds (which have been eliminated), and two privatization funds.

state-owned banks--the Savings Bank, the Agricultural Bank, and the State Commercial Bank of Lithuania--each with several dozen branches throughout the country, along with approximately 20 licensed commercial banks. 1/

Most financial transactions in Lithuania are settled in cash or through payment orders for transfers of funds between banks. A sharp curtailment in shipments of ruble bank notes from Moscow since the summer of 1991, in the context of rapid inflation, had led to an acute shortage of cash in March-April 1992, and a situation had developed in which many government and state-enterprise employees had not been paid for more than a month. Accordingly, on May 1, 1992, the BOL, with authorization from the Government, began to introduce general purpose coupons in ruble denominations--"talonas"--as an interim measure to deal with the shortage of bank notes pending the introduction of a new currency, to be called the "litas". Talonas have been put into circulation in the same way that a central bank normally issues currency, and have been used interchangeably with ruble banknotes on a one-to-one basis as legal tender for all transactions within Lithuania.

In addition to issuing talonas, the BOL has on a number of occasions injected credit into the banking system, in part to alleviate the build-up of interenterprise arrears. The latter problem has not been as severe as elsewhere in the FSU. Despite these credit injections, monetary policy appears to have been restrained through June 1992 (Chart 1). From end-December 1990 through end-June 1992, the net domestic assets of the banking system rose about 165 percent and the broad money supply about 300 percent, while the consumer price index increased 1700 percent. Inflation decelerated through June (Table 3), although it has since picked up again with the passing through of further sharp increases in energy import prices. Since June, the rates of expansion of money and credit have been higher, but still considerably below the rate of inflation (Table 4).

On September 23, 1992, the authorities announced that the ruble would cease to be legal tender as of October 1, following a conversion period in which rubles would be withdrawn from circulation at a 1:1 exchange rate against talonas. Departure from the ruble area was in any case to take place prior to the Board meeting, but the decision to move quickly was prompted by a large inflow of rubles from Ukraine and other ruble area states. A two-stage procedure has been adopted because the talonas was already in wide circulation and could at short notice replace the ruble, and also because problems with the quality of paper on which the litas was printed had not yet been resolved.

1/ For a history of the Lithuanian banking system through early 1992, see SM/92/60, (March 13, 1992), "Lithuania-Pre-Membership Economic Review" Appendix IV.

4. Inflation and real wages

As noted earlier, the Lithuanian authorities acted to liberalize prices ahead of many of their major trading partners within the ruble area. Simultaneously, to protect the country's standard of living, the authorities since the beginning of 1991 have sought to keep nominal wages rising roughly in parallel with the price level, at times by providing direct wage guidelines to state enterprises, and at other times by manipulating indirectly the funds available to enterprises for wage and bonus payments (Chart 2, Table 3).

From the beginning of 1991 through July 1992, the level of consumer prices 1/ increased about 2200 percent. The level of real wages in July 1992 was still about 90 percent of its average level during the first six months of 1991, prior to the onset of the shift of the external terms of trade. Moreover, in mid-August, the authorities had announced a further wage increase, based on preliminary estimates of consumer price data for August and retroactive to August 1, that was projected to keep the real wage index unchanged for August.

5. Output and employment

The disintegration of Lithuania's economic relations with states of the FSU, associated in part with trade disruptions and the difficulties of settling interstate payments, has contributed to a large decline in production over the past two and a half years. It is estimated that real gross domestic product declined by close to 15 percent in 1991 following a decline of about 5 percent in 1990. It also appears that the output decline continued to accelerate in the first half of 1992. On top of this, a severe drought during the summer months has reduced crop yields substantially and led farmers to slaughter a relatively high proportion of their herds. Although this may have largely offsetting effects on total agricultural output this year, it will adversely affect future production of meat and dairy products. In industry and construction, the output fall has been associated with widespread shortages of inputs, which in turn have reflected difficulties in obtaining imports. Lithuania's trade with the CIS states

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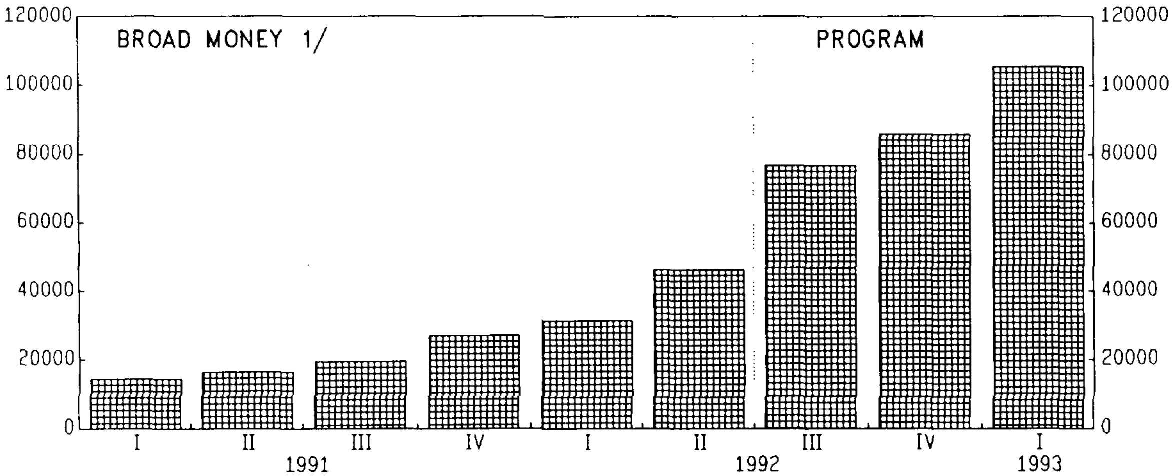
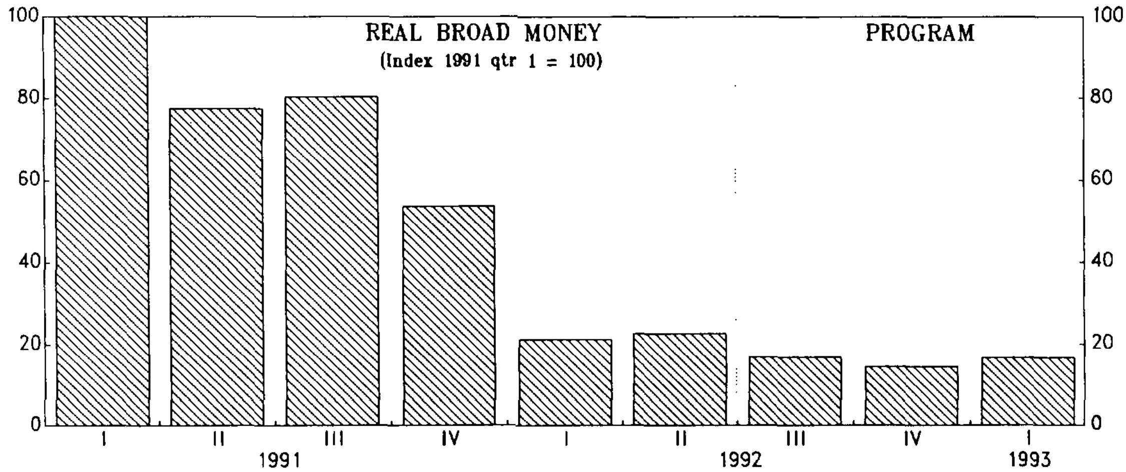
1/ The new consumer price index, which became available in June 1992, is based on a recent household expenditure survey and the introduction of more appropriate sampling techniques, which resulted from technical assistance provided by an expert on price statistics retained as a consultant by the Statistics Department of the Fund. The consumer price index for the period prior to June 1992 reflects the best estimates that the expert was able to compile from available data. For January through May 1992 the index numbers represent estimates of what the new index would have shown. For 1991, the index numbers have been constructed by linking the month-to-month changes in the retail price index prepared previously by Lithuania's Department of Statistics.

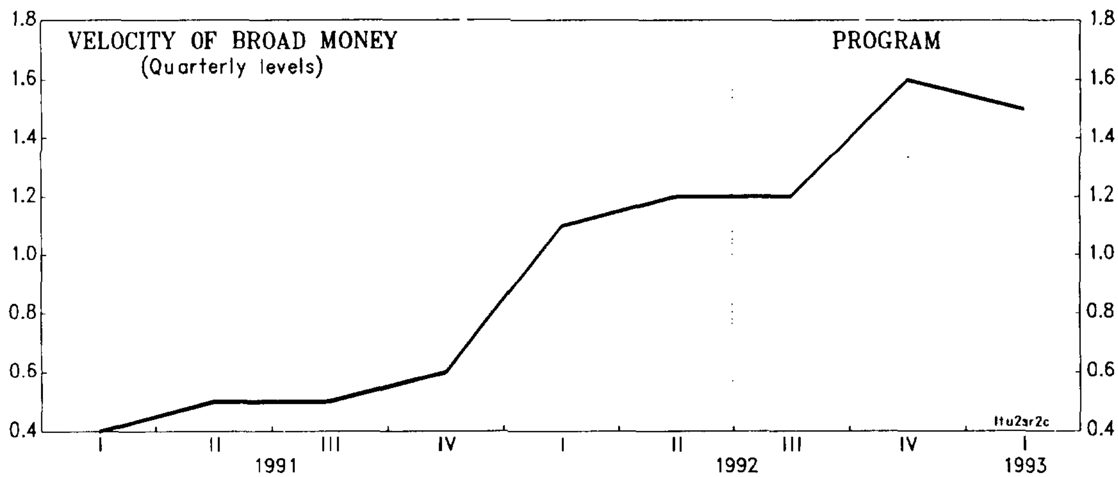
CHART 1

LITHUANIA

MONETARY INDICATORS







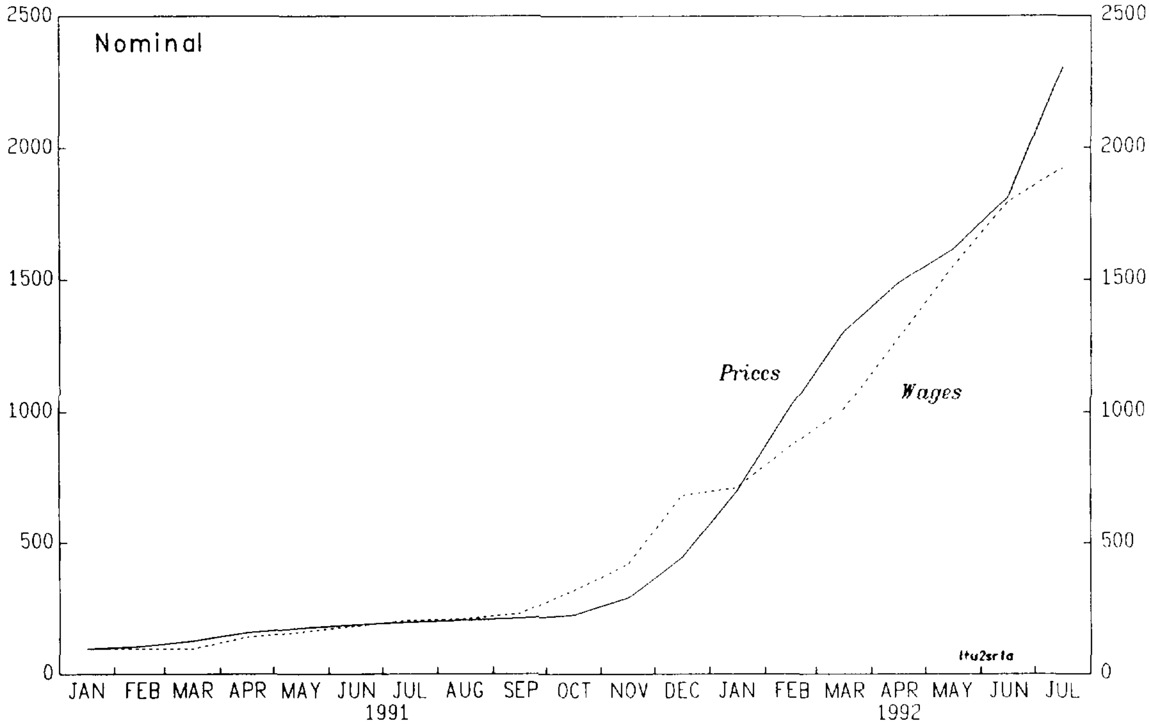
Sources: Data provided by the Lithuanian authorities; and staff estimates.
1/ In millions of rubles or litas equivalents of millions of rubles.

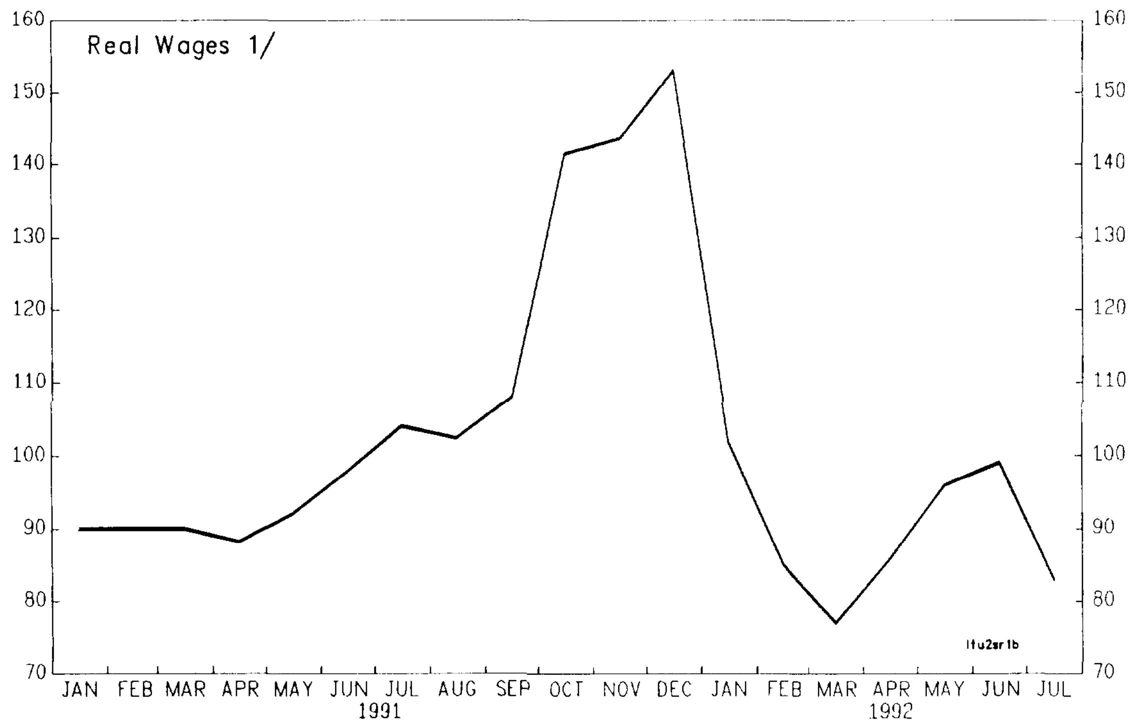
CHART 2

LITHUANIA

NOMINAL AND REAL WAGES

(Jan 1991 = 100)





Source: Data provided by the Lithuanian authorities.

1/ For the first three months of 1991 average wages divided by the averaove quarterly price level.

came more or less to a standstill during the first few months of 1992, partly reflecting the difficulties of negotiating bilateral trade agreements for 1992.

The declines in interstate trade and domestic output have been accompanied by a rapid build-up in both domestic and interstate payments arrears. The Lithuanian authorities estimate that, as of the beginning of August, Lithuanian enterprises were owed payments of ruble 12.9 billion net by enterprises in other states of the FSU. Of these net arrears, ruble 6.1 billion represented net claims on Russian enterprises. At about the same time, the balances in correspondent accounts indicated that Lithuania had built up a net debt of ruble 5.8 billion to the states of the FSU, reflecting net liabilities of ruble 18.3 billion to Russia and net claims of rubles 12.5 billion on the other states.

Compared with output, measured employment has declined relatively little. As of August 1, 1992, the rate of open unemployment amounted to only about 1 percent of the labor force. Perhaps the primary factor limiting the rise in unemployment has been a series of regulations issued by the former Prime Minister that had prohibited enterprises from shedding labor before September 1, 1992. To some extent, enterprises reduced wage costs by introducing unpaid "vacations". Under new regulations, enterprises are permitted to release up to 10 percent of their work forces over a three-month period.

6. External developments

Approximately 90 percent of Lithuania's external trade in recent years has been with states of the FSU, and half of the remaining 10 percent has been with other former CMEA countries. Russia has accounted for more than half of Lithuania's total external trade, with Belarus and Ukraine also accounting for relatively large shares. A high proportion of Lithuania's imports are primary products, many of which--with the notable exceptions of oil and gas--can readily be obtained from sources outside the FSU. By contrast, many of Lithuania's exports are consumer products and specialized manufactures for which there is little apparent demand outside the former CMEA area.

For most of the 1980s, Lithuania recorded deficits or very small surpluses in its trade with other states of the FSU, along with deficits in its other foreign trade. In 1991, it registered a large current account surplus (Table 1), primarily reflecting a substantial shift in its balance of trade with other states of the FSU, as average export prices increased about twice as much as average import prices. As noted earlier, this shift in the terms of trade was temporary, and it apparently reflected Lithuania's progress in liberalizing prices during 1991, ahead of Russia and other major trading partners in the ruble area.

Oil import prices rose progressively during the first half of 1992, to about half the world market level by June. The volume of oil imports during the first half of 1992 fell to about 3 1/2 million tons (little more than half the capacity of Lithuania's refinery at Mazeikiai), compared with imports of 6 million tons in the first half of 1991. Imports of other energy resources (e.g., gas and coal) during the first half of 1992 were also well below the amounts obtained during the first half of 1991. (See Section IV for a further description of balance of payments developments in early 1992.)

The external situation became much more difficult with the movement of oil import prices to around the full world market level by the beginning of September, and with Russia's decision to require payment in advance of any further shipments. As of mid-September, Lithuania had not received any shipments of oil or gas from Russia since early August, and with stocks of energy resources uncomfortably low, the Government had placed restrictions on the provision of hot water.

Lithuania assesses a "statistical tariff" of .01 percent on imports and exports for purposes of recording information on trade flows. There are no licensing requirements or other quantitative limits on imports. By contrast, many categories of exports have faced quantitative restrictions, although these have been progressively reduced or replaced with export taxes over the past several months, and further export liberalization is planned, as explained more fully below. The direct involvement of the Government in arranging trade has also been progressively reduced, and exchange rates have been largely unified in a market-determined system, with plans to move further in each of these areas, as also elaborated below.

Lithuania's official foreign exchange reserves in convertible currencies amounted to US$76 million at the end of June 1992. About US$58 million of these official reserves consisted of 5.1 tons of gold (valued at market prices) that France and the United Kingdom have returned to Lithuania; during July, Sweden compensated Lithuania for another 1.2 tons of gold, valued at US$14.5 million. Since its independence was recognized internationally in August 1991, Lithuania has not accumulated any foreign debt, apart from unsettled balances under bilateral clearing arrangements. Lithuania does not accept responsibility for any of the external debt of the FSU, but the authorities have indicated their willingness to discuss the servicing of US$35.7 million of debts incurred by Lithuanian enterprises through Vneshekonombank. With regard to debts incurred through bilateral clearing arrangements with countries outside the FSU, Lithuania's only imbalance at the end of 1991 was a debt of US$3.2 million to the Czech and Slovak Federal Republic, which it agreed to settle through the export of fertilizer and other products.

III. Policy Discussions and the Program for July 1992 through June 1993

1. Stabilization objectives of the program

The most pressing objective of Lithuania's economic program is to stabilize the economy by adjusting quickly to the deterioration in the external terms of trade, by introducing a new currency and breaking away from the ruble area, and by maintaining sound fiscal and monetary policies supported by a restrictive incomes policy. With the commitment by the authorities to pass through higher energy costs and take other actions to maintain fiscal balance, to freeze wages until November, and to cease using the ruble as legal tender and float the talonas against the ruble as of October 1, it is projected that the monthly rate of inflation will be reduced well into single digits by December 1992, and to about 2 percent by the end of the first quarter of 1993 (Table 3). Moreover, with the financing envisioned to support the program, which would accommodate a current account deficit of close to US$500 million during the program year, it is estimated that the decline in real GDP can be reduced by about 10 percentage points (from current projections without a program) to 22 percent for the program year (Table 2). This GDP projection assumes that supplies of Russian oil and gas become available again before Lithuania's stocks are depleted.

2. Price liberalization

As noted earlier, price controls have been removed on all goods and services except energy products and a small number of goods and services where controls are justified, in the authorities' view, on the basis of social considerations or monopolistic conditions. To continue the price liberalization process, the Government has been moving ahead with anti-monopoly legislation.

In addressing the issue of energy pricing, the program distinguishes between products for which economies of scale make it appropriate to produce and distribute under concentrated industrial structures (specifically, gas, heat, and electricity) and products for which it is appropriate to let prices eventually be determined by market forces (e.g., petroleum products, coal, briquettes, and firewood). Prices of the former products will continue to be regulated, whereas prices of the latter are to be decontrolled by January 1, 1993. The program leaves scope for the Government to continue to subsidize heating and other energy charges to households, provided it continues to accommodate the subsidies within a balanced budget by taxing energy use in other areas. The Government intends to phase out the subsidization of household energy use during 1993.

3. Fiscal policy

The authorities place great importance on fiscal discipline and have set the objective of balancing the general government budget during the remainder of 1992 and the first half of 1993. At present, there is no government securities market to provide a source of nonmonetary financing, but such a market is to be developed by mid-1993.

As of the staff visit in June 1992, revenue and expenditure projections suggested that, under the policies prevailing at that time, and after allowing for an increase effective July 1 in the value-added tax rate (from 15 to 18 percent), the general government accounts for the second half of 1992 would show a deficit at an annual rate of close to 3 percent of GDP. With Parliament about to recess through early September, the policy discussions with former Prime Minister Vagnorius focused, inter alia, on several actions involving excise taxes, which did not require Parliamentary approval. By early September, the specific excise taxes on alcoholic beverages and petroleum products had been converted to ad valorem rates projected to yield additional revenues, and a decision had been taken to raise the ad valorem rate on tobacco products substantially. 1/ A decision had also been taken to reduce tax collection lags. On the expenditure side, the authorities imposed a two-month freeze of government salaries beginning September 1, and had announced domestic energy price adjustments, effective at various dates between the beginning and middle of September, to pass on fully the overall cost of the most recent increases in the prices of imported energy products. In addition, government subsidies and outlays on goods and services are programmed to be reduced in real terms, expenditure commitments are to be monitored closely to match available revenue and to avoid the emergence of payment arrears, the Government's foreign currency budget is to be abolished, and no new extrabudgetary funds are to be created.

These actions, along with the Government's commitment to find ways to raise revenue or limit expenditure further if necessary (including through further increases in petroleum excise taxes), appear adequate at this stage to keep the general government budget in balance through the middle of 1993. The program includes a performance criterion under which the net credit to the general government from the banking system is not to increase between June 30, 1992 and December 31, 1992, and is also not to increase by more than a small seasonal amount through March 31, 1993. The net credit ceilings would be adjusted, however, to the extent that the Government chooses to convert its current net deposit position into assets of the state-owned Savings Bank, which is liable for most household deposits in Lithuania and in need of financial restructuring.

In addition to implementing short-term stabilization measures, the program calls for the adoption of structural measures to strengthen fiscal policy; the implementation of these measures will be monitored during the program reviews. In particular, by the time of the first program review in

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1/ The average tax rate on alcoholic beverages is 63 percent, the tax rates on petroleum products range from 7 to 30 percent, and the average tax rate on tobacco products has been raised from 19 to at least 50 percent.

February 1993, the authorities intend, with technical assistance from the Fund or other sources, to establish a new system of budget and expenditure control within the Ministry of Finance, to improve the design and administration of the general excise tax to make it a full-fledged value-added tax, and to introduce a budget presentation of the consolidated general government based on the methods of accounts of the IMF's Government Finance Statistics. They also plan to begin performing, on an on-going basis, the tasks of linking budgetary projections to macroeconomic variables and policies, planning alternative fiscal policies for different contingencies, and monitoring the execution of the fiscal program. Furthermore, by the time of the second program review in May 1993, the authorities are to take major strides to further improve tax administration and to simplify and harmonize their tax system, including in particular, the enterprise profit and the personal income taxes.

4. Monetary policy and financial sector reforms

As a relatively small country within the ruble area, Lithuania's ability to influence its own inflation rate has been limited. In the months following independence, concerns about monetary instability within the ruble area, along with the difficulties of obtaining supplies of ruble banknotes from Moscow, heightened the already-strong interest in introducing the litas. Authority to decide how and when to introduce the litas had been delegated to a committee of three people: the President of the Supreme Council, the Prime Minister, and the Governor of the Bank of Lithuania.

The November mission initiated discussions with the authorities on the broad elements of monetary policy and inflation control, emphasizing that, by itself, the introduction of the new currency would not provide monetary stability. The mission also expressed concern that the authorities had not yet worked out the arrangements that would be relied upon for settling trade with Russia and other members of the ruble area once a new currency was in use, and stressed in addition the advantages of having sufficient external reserves in place when a new currency was introduced.

By end-June 1992, a series of missions from MAE and STA had provided the technical assistance needed by the authorities to proceed with the financial sector institutional changes and the strengthening of monetary statistics that a Fund-supported program would require. 1/ The modalities of dividing the Bank of Lithuania into legally separate central and commercial banking entities had been largely worked out, the technical procedures for introducing a new currency had been discussed in detail, various steps to strengthen the organization of the central bank and to improve accounting and reporting systems had been taken or identified, training sessions on banking supervision had been provided, the instruments and techniques for conducting monetary policy after introducing a new

1/ See Appendix II.

currency had been discussed extensively, and recommendations had been provided on the key features of the exchange rate system and the organization and operation of the foreign exchange market.

When the mission returned to Vilnius in late August, the separation of the Bank of Lithuania--which required cooperation between the Government and the central bank in creating a new state-owned commercial bank--had not yet taken place. The mission was nevertheless able to prepare a balance sheet for the central bank and to quantify the performance criteria for a stand-by arrangement. These criteria reflected an understanding that a new currency would be introduced as a prior action before approval of a stand-by arrangement. At that time, the decision to use the talonas as an interim currency had not been made.

Because of the relatively large scale of state-owned banks in the financial sector, the policy discussions led to a decision to rely initially on a performance criterion for the net domestic assets (NDA) of the banking system, supported by a system of bank-by-bank credit limits 1/ as well as an indicative limit for the NDA of the central bank. The intention, however, is to move in the near future to a performance criterion for the NDA of the central bank (rather than the NDA of the entire banking system), and to do away with credit limits for individual banks. To this end, as a prior action for a stand-by arrangement, the central bank is to introduce a refinancing facility for auctioning the base money it provides to the banking system (following procedures recommended by the June 1992 technical assistance mission from MAE), along with a second facility through which a bank could borrow to meet its reserve requirements at a penalty interest rate. This interest rate is to be set higher than bank lending rates and significantly higher than the target rate of inflation under the program to discourage banks from using this facility. The introduction of these facilities will enable the authorities to begin to gain experience in using indirect policy instruments to control bank credit expansion, and the effectiveness of monetary control procedures using the new policy instruments is to be assessed carefully during the first program review.

The NDA ceilings are based on projections of broad money and the net foreign assets of the banking system (Table 4). The latter are assumed to change in parallel with the targets for the net international reserves of the central bank, which are described below. Broad money is projected to be consistent with forecasts for real GDP, the estimated path of inflation through October (which assumes 60 percent inflation in September-October combined as higher imported energy prices are passed through), and the target path for inflation thereafter (which includes 8 percent inflation for

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1/ Part of the overall limit on bank credit expansion is to be allocated in a manner that provides scope for new banks to form.

November-December combined). 1/ The broad money projections also build in a sharp increase in velocity during the remainder of 1992 (Chart 1), reflecting the increase in inflation as energy prices are passed through, followed by a moderate decline in velocity thereafter. The indicative limits for the NDA of the central bank (Table 5) are based on the assumption that the ratio of broad money to the monetary base, which has been relatively stable during the past year, will remain at its end-June level. The NDA ceilings were originally expressed in rubles, but have now been translated one-to-one into talonas. Estimates of currency in circulation are likely to be revised following the conversion of rubles into talonas, and the projections and performance targets will be automatically adjusted under the program. More generally the staff will review developments surrounding the currency reform, and will issue a supplement to this paper, prior to the Board meeting, in which it reports on the currency reform and assesses whether any of the program's monetary performance criteria need to be adjusted.

The mission emphasized to the authorities that NDA can be divided into two components--"domestic credit" and "net other domestic assets"--and that net other domestic assets will not be stable in the months ahead. In particular, as financial assistance is received from the G-24, the IBRD, and in the form of commodity grants, the Government is to deposit the counterpart funds in blocked accounts with the Bank of Lithuania. These deposit liabilities of the central bank will reduce net other domestic assets and provide greater scope for domestic credit expansion within the NDA ceilings. The additional domestic credit expansion essentially represents the mechanism for passing through to the domestic economy the balance of payments financing provided by external creditors. The additional spending resulting from the additional credit expansion will lead to an increase in imports (paid for with the foreign exchange loaned to the authorities by external creditors, which will be available for purchase from the authorities by domestic enterprises receiving the additional domestic credit). Ultimately, the broad money supply and domestic inflationary pressures will not be affected.

The mission pointed out to the authorities that the NDA ceilings provided considerable scope for an increase in credit to the agricultural sector to help it cope with the drought. Additional funding of ruble 6 billion had already been proposed by the Government, and the mission

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1/ For purposes of the monetary program, deposits denominated in convertible currencies will be converted at rub 135.9 per U.S. dollar, the market exchange rate prevailing at end-June 1992. The cross exchange rates prevailing on June 30, 1992 will be used to convert items denominated in convertible currencies other than the U.S. dollar. As of end-June 1992, approximately one third of the broad money supply consisted of foreign currency deposits (mainly of state enterprises) valued at these exchange rates. The Bank of Lithuania is to impose limits on the open foreign currency positions of domestic banks.

emphasized that such funding should be provided through the banking system in order to be consistent with meeting the performance criterion on the general government budget. Credit operations designed to unwind the problem of interenterprise arrears are not allowed for under the program. However, the steps being taken in the area of enterprise reform--especially the recent enactment of a bankruptcy law and privatization (see below)--should help importantly to contain the problem to manageable proportions. Developments in interenterprise arrears will be kept under close scrutiny.

The fragile financial situation of the state-owned banks looms as a major burden on the budget and a potential threat to monetary stability. The commercial banks may also be potential sources of financial strain. To begin to address the current balance sheet difficulties of banks, and to provide a sound basis for the medium-term development of a financial system that can allocate capital efficiently, the authorities intend, with technical assistance from the World Bank, to develop by early next year a coherent plan and timetable for the financial restructuring of the existing banking system. Progress in implementing the plan will be assessed during the first program review.

5. <u>Incomes policy</u>

The authorities agreed that, in the very short run, a reduction in real wages by at least 30 percent was necessary for adjusting to the adverse shift in the external terms of trade. Failure to reduce real wages substantially would increase the financial difficulties of enterprises, which could in turn exacerbate the losses in output, employment, and incomes. At the same time, these losses would reduce the Government's tax revenues while increasing the need for social expenditure, thereby posing a threat to fiscal and monetary stability. Accordingly, to achieve the needed real wage reduction, the authorities have imposed a nominal wage freeze for September and October.

The authorities also agreed that the wage freeze through September-October should be followed, beginning in November, with a second stage of the incomes policy involving forward-looking wage guidelines based on the inflation targets set under the program. This would contribute to achieving a sharp slowdown in inflation following the introduction of the new currency. The guideline for the increase in average wages in November was set at the target rate of inflation for November-December combined, which is 8 percent, plus any amount by which inflation in September-October combined exceeds 30 percent. However, should the decline in real wages in September alone prove excessively large, consideration might be given to ending the wage freeze in October, consistent with achieving a real wage decline of at least 30 percent.

The authorities were opposed to introducing a tax-based enforcement mechanism for their incomes policy. Such a mechanism strongly resembled a system that had been tried unsuccessfully under former Soviet President Gorbachev. Lithuanian enterprises had become adept during that experience at circumventing the enforcement mechanism, and in the Government's opinion, the reimposition of such a mechanism not only would be bitterly resented by Parliament and much of the population as a return to Soviet practices, but also might weaken the credibility of the program. Accordingly, as an alternative, the Government agreed to secure the legal authority from Parliament to control wages directly in state enterprises. Such authority will be used, if necessary, to ensure compliance with the wage guidelines.

The implementation of the incomes policy will be a central focus of the program reviews in February and May. Since there are difficulties in using consumer prices to index wages, and because further terms of trade adjustments may occur, the reviews will also assess the adequacy of the targeted real wage adjustment.

6. External policies

The Lithuanian authorities view the removal of exchange and trade restrictions as a critical part of the strategy for introducing a rational structure of relative prices, for exposing domestic monopolies to competition, and for alleviating supply bottlenecks. They intend, from the end of the ruble conversion period on October 1, to establish a floating exchange rate regime with a unified market-determined exchange rate applying to both current and capital transactions. 1/ They also intend to abolish the Government's extrabudgetary foreign currency fund (which has already been substantially limited), to continue to allow residents to convert domestic currency into foreign exchange for all bona fide current international transactions, and to continue to allow nonresidents to repatriate their earnings and their capital. Households and private enterprises will continue to be permitted to hold their savings in foreign currency bank deposits. The authorities indicated to the mission that they were inclined not to introduce a general surrender or repatriation (or domiciliation) requirement, but that they wished to reserve the right to do so in the future. To accommodate this wish, and because it appeared in any case that the authorities would require additional technical assistance to prepare for the introduction of such a requirement, it was stipulated that any surrender requirement imposed in the future would be set at the unified, market-determined exchange rate. Furthermore, for prudential purposes, domestic banks will be expected to comply with accepted regulatory standards for foreign currency exposure, including exposure in rubles after the talonas becomes the only domestic legal tender. The development of the foreign exchange market and experience with floating exchange rates is to be assessed carefully during the program reviews.

1/ Unification will require that various taxes related to foreign exchange transactions, or paid in foreign currencies, be eliminated or replaced with appropriate domestic taxes. The exchange rate will be determined in the market already established by the banks that are licensed to deal in foreign exchange.

The authorities have centralized their official foreign exchange holdings at the Bank of Lithuania and are in the process of centralizing, through the accounts of the Ministry of Finance, all inflows of foreign grants and government borrowing. The centralized system for monitoring, recording, processing, and managing external debt flows is intended to be fully implemented by November 1992.

The program includes performance criteria for net international reserves (NIR) and external debt. Scope is provided for NIR in convertible currencies to decline by US$10 million in the six months through end-December (recognizing the absence of external financing during the third quarter), 1/ but by no more during the next three months. At the same time, the net deficit in Lithuania's correspondent accounts is targeted to decline by US$10 million during the six months through end-December and US$25 million in the nine months through end-March. The targeted reductions in the correspondent accounts deficit assumes that at least some of the net arrears owed to Lithuanian enterprises by enterprises in other CIS republics will be offset against imbalances in the correspondent accounts. The cumulative change in total NIR for the period through end-March will be adjusted at the time of the first program review depending on the outcome of negotiations to clear interstate arrears and settle correspondent account imbalances. The performance ceilings on external debt provide scope for cumulative borrowing of US$150 million through end-December and US$350 million through end-March.

The program includes a number of measures to continue liberalizing the external trade regime. Except for goods that pose risks to national security or health, there are no quantitative restrictions on imports. Most remaining quantitative restrictions on exports are to be phased out by the end of 1992, and in cases where export restrictions are warranted (for example, because of price controls or foreign quantitative restrictions on imports), taxes are to be imposed instead of quotas whenever possible. Other trade-oriented taxes are to be reviewed and simplified; and a rational tariff structure is to be developed, with low and relatively uniform rates, and in accordance with internationally accepted principles. The Government also intends to continue to reduce as rapidly as possible the direct involvement of the state in trade relations. To this end, it intends not to conclude new bilateral trade or payments arrangements after its current arrangements expire at the end of this year.

1/ This criterion reflects an estimated decline in hard currency reserves by US$22 million during the third quarter offset by the receipt of US$14.5 million from Sweden in compensation for 1.2 tons of gold.

7. Structural policies

The Lithuanian authorities recognize that extensive structural changes are necessary to generate an efficient supply response to macroeconomic management, to strengthen incentives for microeconomic units to invest in the economy and engage in productive activities, and to provide a system of social benefits that protects the population against economic hardship. They have held extensive discussions with the World Bank staff on structural adjustment measures, in close consultation with the Fund staff, and agreement has been reached on a number of structural actions relating to the social safety net, anti-monopoly policy, privatization, the legal and institutional framework for commercial activity, enterprise reforms, economic management (including the timely provision of economic statistics), and regional economic policy.

a. Social safety net

The current system of social benefits is broadly based and requires reform. In general, the program places high priority on keeping expenditures consistent with budgetary resources and on redistributing social benefits toward the most needy. As structural measures aimed at protecting the budget during the remainder of 1992, the authorities intend by November to prepare the necessary legislative changes--for quick introduction on a temporary basis if needed--of simplified (possibly flat-rate) structures of unemployment benefits and pension benefits. Looking further ahead, the authorities have set the goal of developing by the beginning of 1993 a plan for the overall medium-term design and financing of the social safety net (pensions, unemployment benefits, family benefits, sick-pay benefits, and other social assistance benefits) within the general Government's budgetary constraints. This will involve defining a poverty line, linked to the cost of a basic subsistence-level consumption basket, to provide a general benchmark for social benefits. The authorities also plan by early 1993 to design and start implementing an effective means-testing system for channeling social benefits to the most vulnerable groups of the population, with the objective of making the system fully operational during the second half of 1993.

b. Anti-monopoly policy

The authorities have already taken actions to remove legal barriers to starting new businesses, to eliminate restrictive licensing requirements for production and distribution, to permit trading by distributors without geographical restrictions, and to begin the splitting up of multi-plant enterprises. Actions to break up large enterprises are to continue, both on a case-by-case basis under the aegis of the relevant branch ministries and in conjunction with the privatization program. A law defining unfair competition and monopoly practices, and identifying penalties for such behavior, has recently been passed by Parliament; and technical assistance has been requested for the further development of accompanying regulations and the evaluation of alternative institutional arrangements to implement and enforce the law, with the intention of having appropriate regulations and institutional arrangements in place before the end of 1992.

c. Privatization

The program calls for the authorities to take additional measures, if necessary, to remain on schedule in privatizing almost all eligible housing and small enterprises by the end of 1992. In this regard, for those enterprises that were not sold the first time they were put up for auction, the Government has lifted restrictions on the amounts of vouchers and cash that citizens can use as a means of payment in subsequent auctions. Moreover, the authorities have indicated their intention to remove such restrictions for auctions of all enterprises once Lithuania withdrew from the ruble area. Other new initiatives are also being launched to speed up the privatization of large enterprises. Most restrictions on privatization to foreign investors were eased in June 1992, except for a small list of reserved activities, and a study is being undertaken to consider more ways to promote foreign private investment. Additional initiatives to encourage privatization of large enterprises include the systematic break-up, where feasible, of such enterprises into small units that are easier to sell (according to guidelines issued earlier this year), and the introduction of a wider variety of privatization techniques. In connection with the latter initiative, the authorities have set the goal of preparing by November, with World Bank assistance, a specific plan for undertaking demonstration privatizations using a number of additional techniques. Progress toward completing the privatization process for large enterprises is to be assessed during the second program review next May.

d. Legal and institutional framework for commercial activity

To further strengthen the legal and institutional framework for commercial activity, a bankruptcy law--drafted with input from OECD experts--has recently been enacted. Efforts are being made to develop accompanying regulations and strengthen the juridical infrastructure necessary to enforce the bankruptcy law, with the objective of making bankruptcy proceedings operational as soon as possible. To eliminate obstacles to commercial activities, restrictions on leasing land and renting business premises are being removed, and the authorities expect to remove all remaining restrictions on land sales by mid-1993. The program calls for a comprehensive review by mid-1993 of all major laws governing commercial transactions (such as laws governing transfers of property and sales, credit, and collateral) with the intention of elaborating and modifying this legislation as appropriate. As additional actions to promote new private investment and commercial activity, a decree has recently been issued requiring the contracting out of public services, and the authorities will intensify their ongoing efforts to disseminate information systematically about relevant legislation, regulations, and sources of external and domestic assistance.

e. Enterprise reforms

The Lithuanian authorities have been undertaking initiatives, in addition to the privatization program, to create independent commercially-oriented entities from previous state-owned conglomerates and large enterprises. Such enterprises were made independent of their founding ministries by early 1992, with complete financial autonomy, and all direct subsidies for current expenditures from the state budget to enterprises have been discontinued. The program calls for completing a study by the end of 1992, with World Bank assistance, to re-examine the present organizational arrangements for state enterprise management and to recommend modifications that would facilitate improved performance. Initiatives are also being undertaken to strengthen financial accounting. Parliament has passed a law to introduce new accounting procedures meeting internationally accepted standards; regulations and accompanying institutional arrangements to implement these accounting procedures are to be prepared by the end of 1992; and training is to be provided with the aim of making the new procedures fully operational during 1993. In addition, the program calls for establishing by the beginning of 1993 an effective system for reporting the financial flows of enterprises. The program also specifies that, by early 1993 and with assistance from the World Bank, the authorities are to begin to undertake thorough studies of selected sectors and large enterprises in order to identify their medium-term restructuring needs, with emphasis on Lithuania's potential to expand production of exportable goods and services.

f. Economic management

During the policy discussions, the mission emphasized to the Lithuanian authorities the need to strengthen considerably the statistical infrastructure and institutional framework for monitoring economic developments and evaluating and coordinating policy. The authorities responded that they would place high priority on providing adequate staffing and training in their ministries and the central bank, and on preparing for adoption as soon as possible a statistics law that would provide the necessary legal authority for data collection. The mission stressed to the authorities that responsibilities for data compilation and evaluation need to be clarified in some areas to ensure that the national accounts, price, monetary, fiscal, and balance of payments statistics become available on a timely basis. Progress on strengthening mechanisms for the collection, compilation, and timely dissemination of statistics--including the strengthening of staffing and training--is crucial for the success of the program and is to be assessed closely during the first program review. The program establishes a committee consisting of representatives of the key economic ministries and the central bank, along with the resident representative of the Fund, to monitor progress under the program and report directly to the Prime Minister. On a different matter, in anticipation of a resumption of public investment, the program sets the goal of establishing by early 1993 a mechanism to establish priorities, determine project evaluation criteria, and appraise project proposals for public investment, and of preparing by mid-1993 the first version of a rolling three-year public investment program.

IV. Balance of Payments Developments and Prospects

1. Balance of payments developments in 1992 and the first half of 1993

Based on preliminary data provided by the authorities, the external current account is estimated to have recorded a small surplus in the first half of 1992, despite a deterioration in Lithuania's terms of trade by almost 15 percent compared with the first half of 1991. The current account surplus reflected a significant improvement in the trade balance in real terms, resulting from a fall in the volume of imports (40 percent) that was considerably larger than the estimated decline in export volume (15 percent). However, these estimates are subject to substantial statistical uncertainties as in the first few months of the year major trade disruptions within the ruble area may have contributed to a considerable underestimation of net imports. In fact, in the first three months of the year the (negative) errors and omissions were almost as large as the recorded surplus in the current account (Table 7). To a large extent, the underestimation of net imports appears to be related to trade with the ruble area as Lithuania accumulated an aggregated deficit in its correspondent accounts that more than offset net arrears owed to Lithuanian enterprises. On the other hand, hard currency reserves of the banking system increased significantly in the first half of 1992, mainly because enterprises transferred foreign currency deposits held abroad to domestic commercial banks.

With import prices for energy having reached world market levels by the beginning of September 1992, Lithuania's terms of trade are projected to deteriorate by almost 40 percent in the program year 1992/93 (July 1992-June 1993). The available external financing projected for Lithuania would permit a partial recovery in the volume of imports, which is expected to arise mainly from trade outside the ruble area. The improved availability of imported inputs is expected to lead to a 17 percent rise in real exports, with the largest increase being projected for exports outside the ruble area. With net services and private transfers amounting to about US$40 million, the current account deficit in the program year is projected at almost US$500 million, or at 13 percent of GDP.

Identified capital inflows, including World Bank financing in the form of an import rehabilitation loan of US$60 million and special assistance for the energy sector emergency investment program financed by the EBRD of about US$50 million, will partly cover this deficit. The remaining financing gap, which is projected to amount to US$285 million, has been largely pledged in the form of special assistance from the EC/G-24. Purchases from the Fund, amounting to about US$60 million within the program year, are expected to be used for building up gross official reserves to a level equivalent to 0.7 month of imports.

It should be noted that the balance of payments estimate for 1992/93 assumes that Lithuania will not service any of the debt of the former Soviet Union apart from the external debt of enterprises in Lithuania. Lithuania's projected debt service payments thus amount to about US$10 million in 1992/93. 1/

2. Medium-term outlook

The medium-term outlook depends crucially on whether effective stabilization policies and the momentum of economic transformation can be maintained as the domestic economy adjusts to the sharp terms of trade shock. This will require sustained determination on the part of the authorities. It will depend as well on the adequate provision of external financial assistance, on the continuing provision of extensive technical assistance, and on the degree to which the industrial countries open their markets to Lithuania's exports.

The staff has prepared a tentative scenario (Table 8) on the assumption that the momentum of reform is maintained beyond the program period. It must be emphasized, however, that the projections are subject to considerable uncertainty, and that the scenario should be regarded as no more than illustrative.

Although the outlook is clouded by the unsettled situation in most of Lithuania's traditional trading partners, Lithuania is expected to become increasingly oriented over the medium term toward countries outside the ruble area. Given Lithuania's liberal trade policy and flexible exchange rate policy, strong percentage gains in export volumes to the convertible currency area are foreseen (starting from a low initial level). These percentage increases, which are assumed to average about 22 percent annually in 1994-97, are likely to be stimulated in large part by significant investments in Lithuania by foreign firms. 2/ As a result, the deficit in the trade balance is assumed to narrow considerably over the medium term to US$125 million in 1997. Net nonfactor services--particularly receipts from tourism and transportation--are also assumed to contribute significantly to an improvement in the current account, which is expected to move from a deficit of almost 10 percent of GDP in 1993 to a deficit of about 1 percent

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1/ If Lithuania accepted responsibility for the share it has been assigned in the debt of the FSU (1.34 percent), it would add about US$44 million to its annual financing gap in interest servicing alone. Lithuania was not, however, a signatory to the Memorandum of Understanding on external debt on October 28, 1991.

2/ By mid-1992, about 1,200 applications for joint ventures with Lithuanian enterprises had been recorded.

of GDP in 1997. At the same time, interest payments are projected to rise considerably, reflecting increased borrowing to meet the country's need for substantial private investment financing as well as its continuing need for exceptional financing.

Net capital inflows are expected to increase only marginally over the medium term, despite higher foreign direct investment flows and larger borrowing through a regular pipeline for foreign financing that is assumed to be established over the next years. The small increase in net capital inflows reflects in part the assumption that principal payments on some of the exceptional financing needed in the first half of the 1990s would start in the second half of the decade.

These scenarios for the current and capital accounts imply that the overall balance of payments will improve from a deficit of almost US$350 million in 1993 to near balance in 1996, before turning into surplus in 1997. Nevertheless, given a targeted reserve increase to the equivalent of 1.7 months of merchandise imports, residual financing gaps--while projected to decline significantly from US$384 million in 1993 to US$63 million in 1997--will remain over the medium term. Although this would leave a need for further exceptional financing in 1993-94, it would appear that in later years financing requirements could be closed with a combination of continued World Bank lending and other private sector flows. Lithuania's outstanding stock of external debt would amount to about 16 percent of GDP by the end of 1997, with debt service payments representing about 3 percent of total exports of goods and nonfactor service and 12 percent of exports to the convertible currency area alone. Because maturities would increasingly fall due in the late 1990s, the debt service ratio would rise significantly beyond the projection period.

In order to keep Lithuania's debt service payments within the country's capacities over the long run, it would seem advisable not to incur financing gaps substantially larger than those projected in the baseline scenario. Accordingly, if the external environment turned out to be less favorable than that envisaged in the baseline scenario--for example, if real exports to the convertible currency area in 1994-97 expanded only two-thirds as rapidly as assumed in the baseline scenario--financial policies would need to be tightened further to slow the increase in domestic absorption. In particular, the rate of increase in real imports would have to be reduced by about 3 percentage points to maintain basically the same financing gaps as those in the baseline scenario, and economic growth would be about 1 percentage point less per year over the medium term. This implies that Lithuania's debt service obligations in 1997 would represent about 4 percent of total exports of goods and services and 15 percent of exports to the convertible currency area.

3. Capacity to repay the Fund

The medium-term balance of payments projections suggest that, while considerable progress will be made toward external viability, Lithuania's financing needs will remain relatively large throughout the period over which repurchase obligations resulting from the proposed stand-by arrangement would be outstanding. While private capital flows are expected to contribute an increasing share to closing the financing gap, a need for financing from official sources is likely to continue. This would probably also entail additional requests for use of Fund resources.

Based on the medium-term projections, use of Fund credit under the proposed arrangement will gradually decline as a proportion of Lithuania's total external debt, from its peak of 17 percent in mid-1993 to 1 percent in 1997 (Table 9). Debt service payments to the Fund would peak at SDR 28.2 million in 1997, which would represent 0.7 percent of total exports of goods and nonfactor services, and 3 percent of exports to the convertible currency area alone.

While it is important to bear in mind that the Lithuanian economy remains vulnerable to exogenous shocks, the total level of projected debt obligations appears to be within Lithuania's servicing capacity. Given the authorities' strong commitment to the implementation of the adjustment program to improve the country's external performance over the medium term, and assuming continued support from the international community to help carry forward the reform program, it is expected that Lithuania will be current in meeting future obligations to the Fund.

V. Prior Actions, Performance Criteria, and Program Reviews

Over the past several months the authorities have undertaken a number of the prior actions that the staff had encouraged during its missions in April/May and June/July. These actions have included: the passing through of higher energy prices and the implementation of other revenue and expenditure measures sufficient to keep the projected general government budget in balance; the legal separation of the commercial and central banking operations of the Bank of Lithuania; the introduction of a new currency to enable Lithuania to leave the ruble area; the centralization of official foreign exchange holdings at the Bank of Lithuania; and various steps to ensure a consistent and adequate statistical reporting system and information base for analyzing macroeconomic developments and monitoring the performance criteria specified under a stand-by arrangement from the Fund.

Prior actions that remain to be taken before approval of the stand-by arrangement would be recommended are: (1) compliance with the principle that ruble bank notes withdrawn from circulation should be held by the Bank of Lithuania pending the results of negotiations with the authorities of Russia (see paragraph 31 of the Memorandum of Economic Policies); (2) the unification of exchange rates along with the abolishment of the Government's remaining extrabudgetary foreign currency fund and surrender requirement (paragraph 44); (3) compliance with the incomes policy measures (paragraphs 41 and 42 and Annex VI) which, among other things, require the Government to secure from Parliament the legal authority to impose direct controls, if necessary, on wages paid by state enterprises; (4) the introduction of monetary policy facilities and the system of bank-by-bank credit limits (paragraphs 36 and 37), which will provide for market-determined interest rates that can be expected to be positive in real terms; (5) the introduction of prudential standards for limiting the foreign currency exposure of banks (paragraph 47); and (6) the repeal of the Government's authority to interfere with interest rate policy (paragraph 40).

The quantitative criteria for monitoring performance under the proposed arrangement (Table 10) are: (1) quarterly ceilings on the net credit of the banking system to the general government; (2) quarterly ceilings on the net domestic assets of the banking system; (3) quarterly floors on total net international reserves with subfloors on net international reserves in convertible currencies (i.e., on net international reserves excluding the net asset position of the Bank of Lithuania on its correspondent accounts with the former Soviet Union); (4) quarterly ceilings on external debt maturing in 1 to 12 years, with subceilings on debt maturing in 1 to 5 years; and (5) a continuous limit on the contracting or guaranteeing of external government debt with maturities of less than one year, except for normal import financing. 1/ Compliance with the obligation not to accumulate payments arrears will also be a performance criterion, as will be compliance with the obligations not to introduce or intensify exchange restrictions, impose or intensify import restrictions for balance of payments purposes, or introduce or modify multiple currency practices, and not to enter into new bilateral trade agreements inconsistent with Article VIII. The proposed quantitative performance criteria are described in Annexes I-V of the Memorandum of Economic Policies, along with the indicative limits established for the net domestic assets of the central bank. Those criteria that were originally expressed in rubles have now been translated one-to-one into talonas. The staff will follow very carefully developments with currency reform, also with the help of the Resident Representative, and some of the criteria may have to be adjusted prior to the Board meeting. The proposed schedule of purchases, along with the projected IMF position and the projected payments to the Fund, are shown in Tables 11, 12 and 13.

Progress under the proposed stand-by arrangement is to be reviewed before February 28, 1993 and again before May 31, 1993. Quantitative performance criteria for end-June 1993 will be established at the time of the February 1993 review. Thus, the second and third purchases under the arrangement would be subject, respectively, to the observance of the performance criteria for the end-December and end-March test dates, along

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1/ For purposes of monitoring short-term external debt, liabilities on the correspondent accounts with FSU countries would be regarded as normal import financing.

with completion of the respective reviews. The reviews will focus on general macroeconomic developments and policy performance, including compliance with the incomes policy measures.

The reviews of incomes policy measures will address, inter alia, the issue of how much to adjust the wage guidelines to compensate for any observed deviations between actual and target inflation during the months prior to each review. Ideally, a broad-based political consensus on these adjustments will be sought and achieved. Less than full compensation might be warranted if there were evidence based on external trade and exchange rate developments of a need for additional downward adjustment of real income for the country as a whole, and if there was a political preference to achieve this through nominal wage adjustment rather than other approaches.

The reviews will also focus on progress in implementing certain key structural measures. Specifically, the first review will look for progress in: (1) strengthening public expenditure control, tax administration, and budgetary planning; (2) using the new monetary policy instruments effectively; (3) implementing the plan for the financial restructuring of the banking system; and (4) strengthening mechanisms for the collection, compilation, and timely dissemination of statistics. The second review will assess: (1) the development of the foreign exchange market and the experience with floating exchange rates; (2) the simplification of the various tax systems; (3) the development of a Government securities market; and (4) progress toward completing the privatization process.

VI. Staff Appraisal

The Lithuanian authorities have designed a program of sound stabilization policies and wide-ranging structural reforms. While the uncertainties are inevitably large, the commitment to economic transformation is strong, as evident both from the extent to which Lithuania has already moved ahead with price liberalization, privatization, and other structural policies, and from the comprehensiveness and plans for speedy implementation of the structural measures included in the program.

The stabilization measures envisaged in the program will entail great difficulties for the population, but the authorities regard these measures as necessary and unavoidable. The general government budget has been held in balance through 1991 and the first half of 1992. Moreover, the staff's assessment is that the decisions taken to pass on higher energy costs fully and promptly, to raise various tax rates, and to reduce government spending in real terms, will be sufficient to keep the budget in balance through the end of 1992. Furthermore, in light of the uncertainties surrounding the projections, the authorities have committed themselves to take additional actions if necessary to maintain budget balance through the first half of

1993, and will obtain technical assistance during the coming months to strengthen public expenditure control, tax administration, and budgetary planning.

The increase in energy prices will be particularly difficult for households and industry. By early August, the average ruble price of imported oil and gas was already a factor of 100 higher than its end-1991 level (more than 75 times higher relative to the general price level), and the authorities estimate that energy import prices by end-1992 will be 280 times higher on average than their end-1991 levels. Household energy charges are being increased less rapidly (with taxes imposed on other types of energy use to protect the budget), although the authorities intend to phase out energy subsidies to households by the end of 1993. The burden on industry is to be cushioned through an incomes policy to reduce average wages at least 30 percent in real terms, and a wage freeze has been announced for September-October.

For the country as a whole, a large real income loss is an unavoidable consequence of the sharp adverse shift that has taken place in Lithuania's terms of trade as import and export prices have moved toward world market levels. The staff strongly supports the authorities' strategy of spreading the income loss widely through a policy of restraining wage incomes and will carefully assess the adequacy of the targeted real wage adjustment during the program reviews.

With a two-tier banking system now established and Lithuania no longer a part of the ruble area, it is essential for the Bank of Lithuania to begin implementing immediately the new instruments and procedures that it has designed, in consultation with technical assistance missions from MAE, for purposes of conducting monetary policy effectively. The program aims to achieve a sharp reduction in inflation over the next two or three months, which is reflected in the specification of both the quantitative performance criteria on the net domestic assets of the banking system and the wage guidelines for the period following withdrawal from the ruble area.

In addition to freezing wages during September-October, the authorities expressed broad support for a system of forward-looking wage guidelines consistent with target inflation for the period beginning in November. The Government feels that control over both the minimum wage rate and wages in budgetary institutions, along with moral suasion, will be adequate to achieve the guidelines. However, in view of the risk that this might not be the case, the Government agreed to secure the authority from Parliament to impose direct controls on state enterprises if necessary to enforce the guidelines, to which it is strongly committed.

Lithuania already has a system of market-determined exchange rates for most commercial transactions, and is to unify the exchange rate for current and capital transactions prior to the Board's consideration of the stand-by arrangement. Convertibility will be continued for all current international transactions, and for capital transactions by nonresidents, as will be the right of households and enterprises to hold foreign-currency deposits in the domestic banking system. Trade arrangements also are relatively liberal already and will continue to be liberalized.

Problems with the settlement of interstate payments have been a major factor in undermining trade with the CIS, and Russia's recent insistence on payment in advance has brought imports of oil and gas to a halt since early August. The Lithuanian authorities have been negotiating a number of issues relating to trade and settlements with Russia and other CIS republics. The success of Lithuania's economic program could depend critically on the early resolution of these issues--particularly as these bear on Lithuania's ability to secure adequate supplies of oil and gas, given that existing pipeline and harbor facilities severely constrain Lithuania's ability to shift to alternative sources of supply. The staff encourages the authorities to make every effort to bring these negotiations quickly to a satisfactory conclusion.

Although projections of the external current account are highly uncertain, the staff estimates that a current account deficit of nearly US$500 million will have to be accommodated during the period July 1992 through June 1993 if the decline in real GDP is to be limited to about 22 percent over the program year. After allowing for private capital flows, identified official export credits, World Bank and EBRD lending, and a build-up of reserves financed mainly from Fund purchases, the residual financing gap is about US$285 million, which has been largely pledged as special assistance from the EC/G-24. It is crucial that a substantial part of this financing becomes available early in the program period to arrest the steep fall in output.

Although further exceptional financing will be needed in 1993 and 1994, the staff expects that the financing gap could be closed in later years with a combination of continued World Bank and EBRD lending and private capital flows. On the basis of the staff's tentative projections and the authorities' firm commitment to adopt the policies needed to strengthen the balance of payments over the medium term, the overall level of Lithuania's external debt is expected to remain moderate, thus maintaining Lithuania's capacity to service its debt. It is therefore expected that Lithuania will be able to repay the Fund as scheduled.

The Government and the Bank of Lithuania have designed an economic policy program that merits strong support from the international community. Although the overall success of the stabilization effort will be at risk if the incomes policy cannot be implemented effectively, if financial rigor cannot be maintained, or if the steep fall in output cannot be arrested, the authorities have indicated a strong commitment to overcome the first two dangers, and the early provision of external financing will contribute importantly to the revival of output. This in turn will allow Lithuania to adjust without straining its debt-servicing capacity, and will eliminate its need for exceptional financing over the medium term.

The staff believes that the macroeconomic and structural policies set forth in the Memorandum of Economic Policies for the program year July 1, 1992 through June 30, 1993 are adequate to make significant strides toward achieving the Government's objectives of adjusting quickly to the external terms of trade shock, continuing to strengthen the framework for a private market economy, limiting the effects on output arising from both the shift in the terms of trade and the transformation of the economy, providing an effective social safety net, and bringing inflation down sharply. Accordingly, the staff recommends approval of Lithuania's request for an 11-month stand-by arrangement in the amount of SDR 56.925 million (82.5 percent of quota, equivalent to annual access of 90 percent of quota) in support of its economic stabilization and reform program.

VII. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

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.

Table 1. Lithuania: Selected Economic Indicators

	1991	1992	1992				1993	
		Projected			Projected			
			I	II	III	IV	I	II
Output, prices and wages								
GDP at constant prices 1/	-13.4	-25.1	-14.3	-22.4	-29.2	-33.9	-15.6	-3.9
Consumer price index 2/	216.0	1,217.0	214.3	62.7	86.5	64.1	9.2	7.7
Wage index 2/	...	...	82.6	78.7	...	...	...	...
			(In millions of U.S. dollars)					
External sector								
Exports	6,786	1,108	96	231	341	440	463	489
Imports	4,937	1,311	56	259	405	591	655	621
Current account	2,259	-162	47	-12	-52	-145	-185	-117
In percent of GDP	10.0	-7.0	...	...	...	...	...	...
			(In percent of GDP)					
				1st.half		2nd.half		
General government								
Revenue	41.2	38.2	...	41.2	...	37.2	...	...
Expenditure	38.4	37.9	...	39.9	...	37.2	...	...
Surplus/deficit	2.8	0.3	...	1.3	...	--	...	...
			(Percentage change from previous period)					
Money and Credit 3/								
Domestic credit	170.0	811.6	42.5	115.6	95.2	52.0	29.8	...
Broad money	133.2	270.6	15.8	48.2	65.0	25.0	10.0	...
Velocity (quarterly level)	...	...	1.1	1.2	1.2	1.6	1.5	...
Interest rates								
(in percent per annum)								
Deposit 4/	0.5	...	20.5	40.5	...	...	...	...
Credit	6.7	...	25.0	55.0	...	...	...	...

Sources: Information supplied by the Lithuanian authorities; and staff estimates.
1/ Twelve-month percentage change. 2/ Percentage change from previous period.
3/ End-period. 4/ Enterprises at Bank of Lithuania.

Table 2. Lithuania: Gross Domestic Product

(In millions of rubles at 1990 prices)

	1991	1992	1993	1992/93 Program Year
Gross Domestic Expenditure	12,850	9,400	9,525	9,325
Percentage change in 12 months	...	-26.8	1.3	-17.9
Household consumption	6,700	4,850	5,000	4,875
Percentage change in 12 months	...	-27.6	3.1	-17.3
Government consumption	2,500	2,525	2,475	2,500
Percentage change in 12 months		1.0	-2.0	-1.0
Gross fixed cap formation	2,900	2,125	2,000	2,175
Percentage change in 12 months		-26.7	-5.9	-10.5
Stock changes	750	-100	50	-225
Contribution to GDP (in percent)	...	-7.6	1.8	...
Foreign trade balance	-1,683	-1,041	-1,186	-1,409
Contribution to GDP (in percent)	...	5.7	-1.7	...
Gross Domestic Product (real)	11,167	8,359	8,339	7,916
Percentage change in 12 months	...	-25.1	-0.2	-22.1

Sources: Information provided by the Lithuanian authorities; and staff estimates.

Table 3. Lithuania: Consumer Prices

	Consumer Prices 1/		Average Wages			Real Wages 2/
	Index	Percent Change	Rubles	Index	Percent Change	Index
1991						
January	100	...	321 3/	100 3/	...	90 4/
February	108	8.4	321 3/	100 3/	...	90 4/
March	127	17.1	321 3/	100 3/	...	90 4/
April	161	27.1	456	142	42.1	88
May	177	9.6	522	163	14.5	92
June	188	6.6	590	184	13.0	98
July	199	5.5	666	207	12.9	104
August	207	4.2	682	212	2.4	103
September	214	3.5	740	231	8.5	107
October	227	6.0	1029	321	39.1	141
November	291	27.8	1342	418	30.4	144
December	445	53.0	2185	681	62.8	153
1992						
January	696	56.5	2279	710	4.3	102
February	1,023	47.1	2798	872	22.8	85
March	1,306	27.6	3240	1009	15.8	77
April	1,490	14.1	4118	1283	27.1	86
May	1,617	8.5	4978	1551	20.9	96
June	1,815	12.3	5768	1797	15.9	99
July	2,309	27.2	6172	1923	7.0	83
August	2,863	24.0	...	...	...	...
September 5/	4,009	40.0	...	...	...	...
October 5/	4,810	20.0	...	...	...	...
November 5/	5,051	5.0	...	...	...	...
December 5/	5,202	3.0	...	...	...	...
1993 5/						
January	5,358	3.0	...	...	...	...
February	5,492	2.5	...	...	...	...
March	5,602	2.0	...	...	...	...

Source: Information provided by the Lithuanian authorities.

1/ Based during 1991 on the retail price index for goods and services in its linked inter-monthly version, from January through May 1992 on estimates of what the new consumer price index would have shown, and in June and July 1992 on the fully developed consumer price index.

2/ Average ruble wages divided by the level of consumer prices.

3/ Average for the first quarter of 1991.

4/ Average wages divided by the quarterly average price level.

5/ Targeted/projected.

Table 4. Lithuania: Monetary Survey

(End-period; in millions of rubles)

	1992 June	1992 Sept.	1992 Dec.	1993 Mar.
Net foreign assets 1/	15,669	15,958	15,958	18,183
In convertible currencies, net	22,659	21,585	21,585	21,581
Correspondent account	-6,990	-5,626	-5,626	-3,398
Net domestic assets	30,892	60,867	80,074	87,452
Domestic credit	32,299	63,043	95,826	124,391
Net credit to government	-4,719	-4,700	-4,700	-4,000
Other	37,018	67,743	100,526	128,391
Other items, net	-1,407	-2,176	-15,752	-36,939
Blocked government accounts 2/	-396	-1,076	-14,652	-35,839
Broad money	46,561	76,826	96,032	105,635
Currency	10,005	15,645	19,556	21,511
Memorandum items:				
Broad money growth 3/	48	65	25	10
Inflation 3/	39	121	30	8

Sources: Information provided by the Lithuanian authorities; and staff estimates.

1/ Converted at rub 135.9= US$ 1 (end-June 1992 exchange rate).
2/ Financing gap (G24), IBRD, and commodity grants.
3/ Percentage change from previous quarter.

Table 5. Lithuania: The Central Bank of Lithuania

(In millions of rubles; end of period)

	1992 June	1992 Sept.	1992 Dec.	1993 Mar.
Net foreign assets	3,330	3,619	3,619	5,844
Net domestic assets	10,451	19,111	24,793	25,409
Reserve money	13,781	22,730	28,412	31,253
Memorandum items				
Broad money	45,561	76,826	96,032	105,635
Broad money/reserve money	3.4	3.4	3.4	3.4

Source: Information provided by the Lithuanian authorities.

Table 6. Lithuania: General Government Budget 1/
(In percent)

	1991	1992 Prog.	1992 1st half Prel.	1992 2nd half Prog.
I. Total revenue	41.2	38.2	41.2	37.2
Tax revenue	38.6	37.3	39.0	36.7
Taxes on income and profit	11.8	12.7	14.1	12.1
Taxes on enterprises	6.7	7.7	8.4	7.5
Taxes on individuals	5.1	5.0	5.8	4.7
Payroll or social security	9.4	9.3	9.9	9.1
Taxes on goods and service	14.8	14.5	14.0	14.7
Turnover taxes–Excises	12.7	5.7	6.3	5.5
Value–added tax	0.7	8.8	7.5	9.3
Special Funds–state	1.4	...	0.1	...
Property taxes	1.2	0.2	0.1	0.2
Foreign trade	0.1	0.1	0.1	0.1
Other taxes	1.4	0.6	0.9	0.6
State fees and charges	0.4	0.2	0.4	0.2
Taxes on fixed assets	1.0	0.4	0.5	0.3
Taxes on pollution–state	...	...	...	...
Taxes on natural res.–stat	...	...	...	...
Other	...	...	...	...
Nontax Revenue 2/	2.6	0.9	2.2	0.4
Penalty–state	0.2	0.1	0.2	0.1
Other	2.5	0.8	2.1	0.3
II. Total expenditure	38.4	37.9	39.9	37.2
Current expenditure	33.5	33.7	37.3	32.4
Social outlays 3/	22.0	22.8	23.3	22.7
Subsidies	5.4	1.8	3.4	1.2
Road maintenance	0.3	...	...	...
Government functions 4/	2.0	2.8	3.3	2.7
Other 5/	3.8	6.2	7.3	5.8
Investment	2.8	4.3	2.9	4.8
National economy	2.8	4.3	2.9	4.8
Lending minus repayments	2.2	–0.1	–0.3	...
Lending	...	...	0.1	...
Repayments (–)	...	–0.1	–0.4	...
Surplus or deficit (–)	2.8	0.3	1.3	...
Financing	–2.8	–0.3	–1.3	...
Domestic	–2.8	–4.8	–1.8	–5.9
Net Bank credit	–2.8	–0.3	–1.3	...
Excluded Bank deposits	–0.2	–4.5	–0.9	–5.8
Foreign	...	4.4	0.5	5.9
Grants	...	0.6	...	0.8
Net borrowing	...	3.8	0.5	5.0
Borrowing	...	3.8	0.5	5.0
Amortization(–)	...	...	...	...
Memorandum Items:				
Fiscal balance (% GDP)	2.8	0.3	1.3	...
GDP	39,104	331,100	87,480	243,620

Sources: Ministry of Finance, Ministry of Social Security and staff estimates.
1/ Including the national budgets,Social Insurance Fund, Foreign Currency Fund, and Privatization Funds.
2/ Including other revenue of Social Insurance Fund, Foreign Currency Fund, and the Privatization Funds operations.
3/ Excluding capital expenditure for activities other than those classified under "national economy".
4/ Covering administrative and other functions, including defense and police starting in 1991.
5/ Including expenditures of the Social Insurance Fund and Foreign Currency Fund.

Table 7. Lithuania: Balance of Payments 1991-93
(in millions of U.S. dollars)

	1991	1992	1992 Q1	1992 Q2	1992 Q3	1992 Q4	1993	1993 Q1	1993 Q2
Trade balance	1,848	-203	40	-28	-64	-151	-534	-192	-133
Exports	6,786	1,108	96	231	341	440	1,991	463	489
CIS and Baltics	6,441	953	82	200	298	374	1,647	381	407
Other countries	345	155	13	32	44	67	344	82	84
Imports	4,937	1,311	56	259	405	591	2,525	655	621
CIS and Baltics	4,463	1,110	47	221	342	499	2,005	537	495
Other countries	475	202	9	38	63	92	520	118	126
Services (net)	392	29	4	13	9	3	37	4	13
Interest (net)	...	3	2	1	--	--	-14	-2	-3
Private transfers	...	12	3	3	3	3	14	3	3
Current account balance	2,259	-162	47	-12	-52	-145	-484	-185	-117
Capital account	...	143	2	21	40	80	141	68	56
Foreign direct investment	...	25	--	1	9	15	50	22	19
Private flows	...	24	2	22	--	--	--	--	--
Official transfers	...	47	--	2	12	33	25	15	10
Medium- and long-term loans (net)		47	--	-4	19	32	66	31	27
Errors and Omissions	...	-46	-46	...	...	...	...	...	...
Overall balance	...	-65	3	10	-12	-65	-343	-117	-61
Financing	...	--	-3	-10	12	--	-43	-16	-25
Net foreign assets	...	--	-3	-10	12	--	-43	-16	-25
Central Bank	...	40	-1	29	12	--	-43	-16	-25
IMF purchases (net)	...	24	--	--	--	24	54	19	19
Reserves (-=increase)	...	16	-1	29	12	-24	-97	-35	-44
Deposit money banks	...	-40	-2	-38	--	--	--	--	--
Financing gap	--	65	--	--	--	65	386	133	86

Source: Lithuanian authorities; and staff projections.

Table 8. Lithuania: Medium-term Outlook, 1991-97
(in millions of U.S. dollars)

	1991	1992	1993	1994	1995	1996	1997
Trade balance	1,848	-203	-534	-402	-292	-211	-125
Exports	6,786	1,108	1,991	2,542	2,994	3,418	3,873
CIS and Baltics	6,441	953	1,647	2,056	2,395	2,702	3,055
Other countries	345	155	344	487	599	716	819
Imports	4,937	1,311	2,525	2,945	3,287	3,629	3,998
CIS and Baltics	4,463	1,110	2,005	2,345	2,611	2,882	3,174
Other countries	475	202	520	599	676	746	824
Services (net)	392	29	37	33	33	39	49
Interest (net)	...	3	-14	-35	-50	-55	-53
Private transfers	...	12	14	15	17	19	21
Current account balance	2,259	-162	-484	-354	-243	-153	-56
Capital account	...	142	141	134	153	155	155
Foreign direct investment	...	25	50	60	70	80	90
Private flows	...	24	--	--	--	--	--
Official transfers	...	47	25	--	--	--	--
Medium- and long-term loans	...	47	66	74	83	75	66
Disbursements	...	59	73	80	87	95	100
Amortization	...	12	7	6	4	20	34
Errors and Omissions	...	-46	...	...	...	...	...
Overall balance	...	-65	-343	-220	-89	2	99
Financing	...	--	-41	-80	-103	-136	-162
Net foreign assets	...	--	-41	-80	-103	-136	-162
Central Bank	...	40	-41	-80	-103	-136	-162
IMF purchases	...	24	56	--	-3	-26	-37
Reserves (- = increase)	...	16	-97	-80	-100	-110	-125
Deposit money banks	...	-40	--	--	--	--	--
Financing gap	--	65	384	300	192	134	63
Memorandum items							
Export volume (1991=100)							
CIS and Baltics	100	75	64	68	71	75	79
Other countries	100	46	102	143	174	206	233
Import volume (1991=100)							
CIS and Baltics	100	65	54	54	56	57	59
Other countries	100	42	109	126	142	156	171
Terms of trade (1991=100)	100	56	53	56	57	58	59
Current account balance in percent of GDP	10	-7	-10	-6	-4	-2	-1
Gross official reserves (months of imports)	--	0.4	0.7	0.9	1.2	1.4	1.7

Source: Lithuania authorities; and staff projections.

Table 9. Lithuania: Indicators of Capacity to Repay the Fund, 1992-97

	1992	1993	1994	1995	1996	1997
			(in millions of SDRs)			
Outstanding use of Fund credit	17.3	56.9	56.9	54.8	36.3	10.0
IMF obligations	0.1	2.4	4.1	6.1	22.0	28.2
Repurchases	--	--	--	2.1	18.5	26.3
Charges	0.1	2.4	4.1	4.0	3.5	1.9
			(in percent)			
Outstanding use of Fund credit as a ratio of						
GDP	1.0	1.6	1.3	1.1	0.7	0.2
Exports of goods and nonfactor services						
Total exports	1.9	3.5	2.8	2.3	1.3	0.3
exports to convertible currency area	7.6	14.6	11.0	8.7	4.9	1.2
External debt	16.7	15.3	9.6	7.2	4.1	1.0
Net official international reserves	102.6	122.7	55.0	31.0	13.2	2.6
Quota	25.0	82.5	82.5	79.4	52.6	14.5
Debt service obligations to IMF as a ratio of						
GDP	--	0.1	0.1	0.1	0.4	0.3
Exports of goods and nonfactor services						
Total exports	--	0.1	0.1	0.2	0.6	0.7
Exports to convertible currency area	--	0.6	0.8	1.0	3.0	3.4
Total debt service	0.8	10.5	9.9	10.8	27.8	29.2
Net official international reserves	0.6	5.2	4.0	3.4	8.0	5.2

Sources: Lithuanian authorities; and staff estimates.

Table 10. Lithuania: Quantitative Performance Criteria 1/

Variable and Periods	Amounts	
	(In millions of talonas)	
I. Limits for the cumulative change in net domestic assets of the banking system 2/ 3/		
Position on June 30, 1992	30,900	
Indicative limit for September 30, 1992	61,000	
Limit through December 31, 1992	80,000	
Limit through March 31, 1993	87,500	
II. Limits on net credit to general government		
Estimates for June 30, 1992	-4,700	
Indicative limit for September 30, 1992	-4,700	
Limits on:		
December 31, 1992	-4,700	
March 31, 1993	-4,000	
	(In millions of U.S.dollars) Minimum	
	Total	Convertible currencies
III. Targets for the minimum cumulative change in net international reserves of the Bank of Lithuania		
Position on June 30, 1993	25	76
Cumulative change from June 30, 1992		
December 31, 1992	--	-10
March 31, 1993	15	-10
IV. Limits on disbursements of public and publicly guaranteed medium- and long-term external debt cumulative from June 30, 1992		
	Maximum limits	
During the period from June 30, 1992 to:	1-12 year maturity	1-5 year maturity
December 31, 1992	150	50
March 31, 1993	350	125
V. Limit on government debt of up to one year 4/		
Duration of the stand-by arrangement		--
VI. No accumulation of external payments arrears by the Government.		

Source: Stand-by arrangement.

1/ Definitions of the concepts to be measured are included in the Annexes to the Memorandum of Economic Policies. Amounts expressed in talonas will be redenominated into litas when the litas is introduced.

2/ In addition, indicative ceilings have been established for net domestic assets of the central bank of Lithuania. 3/

	(In millions of talonas)
Estimate for June 30, 1992	10,450
Indicative limit for September 30, 1992	19,100
Indicative limit through December 31, 1992	24,800
Indicative limit through March 31, 1993	25,400

3/ The limits will be adjusted depending on the amount of rubles converted into talonas.

4/ Except for normal import-related credits.

Table 11. Lithuania: Schedule of Purchases
Under Stand-By Arrangement

Amount of Purchase	Scheduled availability date	Conditions necessary for purchase
SDR 17.2500 million	On or after Board approval	Board approval of stand-by arrangement
SDR 13.2250 million	On or after February 28, 1993	Compliance with quantitative performance criteria as of December 31, 1992 and completion of program review
SDR 13.2250 million	On or after May 31, 1993	Compliance with quantitative performance criteria as of March 31, 1993, and completion of program review
SDR 13.2250 million	On or after August 31, 1993	Compliance with quantitative performance criteria as of June 30, 1993

Source: Stand-By Arrangement.

Table 12. Lithuania: Projection of IMF Position During
Period of Proposed Stand-By Arrangement

	1992	1993		
	Oct.-Dec.	Jan.-March	April-June	July-Sept.
	(in thousands of SDRs)			
Purchases	17,250	13,225	13,225	13,225
Tranche policies	17,250	13,225	13,225	13,225
Ordinary resources	17,250	13,225	13,225	13,225
Total Fund credit				
Outstanding (end of period)	17,250	30,475	43,700	56,925
Tranche policies	17,250	30,475	43,700	56,925
	(in percent of quota) 1/			
Total Fund credit				
Outstanding (end of period)	25.00	44.17	63.33	82.5
Tranche policies	25.00	44.17	63.33	82.5

1/ Lithuania's quota is SDR 69 million.

Table 13. LITHUANIA - Projected Payments to the Fund as at July 31, 1992
(in millions of SDR's)

	Overdue	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Beyond	Total
. Obligations from Existing Drawings													
1. Principal													
a. Repurchases	-	-	-	-	-	-	-	-	-	-	-	-	-
b. ESAF/SAF Repayments	-	-	-	-	-	-	-	-	-	-	-	-	-
c. TF Obligations	-	-	-	-	-	-	-	-	-	-	-	-	-
2. Charges and Interest 1/	-	-	-	-	-	-	-	-	-	-	-	-	-
Total Obligations 2/	-	-	-	-	-	-	-	-	-	-	-	-	-
(percent of quota)	-	-	-	-	-	-	-	-	-	-	-	-	-
. Obligations from Prospective Drawings													
1. Principal													
a. Repurchases	-	-	-	-	2.1	18.5	26.3	9.9	-	-	-	-	56.9
b. ESAF/SAF Repayments	-	-	-	-	-	-	-	-	-	-	-	-	-
c. TF Obligations	-	-	-	-	-	-	-	-	-	-	-	-	-
2. Charges and Interest 1/	-	.1	2.4	4.1	4.0	3.5	1.9	.3	-	-	-	-	16.5
Total Obligations	-	.1	2.4	4.1	6.1	22.0	28.2	10.2	-	-	-	-	73.5
(percent of quota)	-	.1	3.5	5.9	8.9	32.0	40.9	14.9	-	-	-	-	106.5
. Cumulative (Existing and Prospective)													
1. Principal													
a. Repurchases	-	-	-	-	2.1	18.5	26.3	9.9	-	-	-	-	56.9
b. ESAF/SAF Repayments	-	-	-	-	-	-	-	-	-	-	-	-	-
c. TF Obligations	-	-	-	-	-	-	-	-	-	-	-	-	-
2. Charges and Interest 1/	-	.1	2.4	4.1	4.0	3.5	1.9	.3	-	-	-	-	16.5
Total Obligations 2/	-	.1	2.4	4.1	6.1	22.0	28.2	10.2	-	-	-	-	73.5
(percent of quota)	-	.1	3.5	5.9	8.9	32.0	40.9	14.9	-	-	-	-	106.5

1/ Projections are based on current rates of charge, including burden-sharing charges where applicable, for purchases in the GRA, and on current interest rates for SAF, ESAF and Trust Fund. The current SDR interest rate is assumed for net use of SDRs.
2/ Overdue obligations (if applicable) will be settled in full at close of business August 1, 1992 .

Prepared by Treasurer's Department

Lithuania--Fund Relations

(As of August 31, 1992)

I. Membership status: Joined April 29, 1992/Article XIV

II. General Resources Account:	SDR Million	Percent of Quota
Quota	69.0	100.0
Fund holdings of currency	None	--
Reserve position in Fund	None	

III. SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	None	--
Holdings	None	--

IV. Outstanding Purchases and Loans:

None

V. Financial Arrangements:

None

VI. Projected Obligations to Fund:

None based on existing use of resources.

Table 14. Lithuania: Technical Assistance From the Fund, 1991-92

Department	Subject/Identified Need	Action	Time	Counterpart 1/
MAE	General assessment of the legislative/institutional framework and needs for technical assistance	Mission	Dec. 91	BOL
MAE	Issues relating to separation of commercial and central banking functions of BOL, central bank powers and independence, and organization of the central bank	Mission	March 92	BOL
FAD	Issues relating to tax policy and administration, budgetary procedures for expenditure control and monitoring, and the social safety net	Mission	March 92	MOF
STA	Analysis of current price statistics and initiation of an improved Lithuanian household expenditure survey as steps toward an improved consumer price index	Consultant's visit	March 92	DOS
STA	Provision of training in the methodologies for financial statistics; establishment of procedures for collection and compilation of balance of payments, government finance, and money and banking statistics	Mission	March/ April 92	BOL MOF MOE DOS
STA	Balance of payments statistics	Mission	May 92	MOE DOS
MAE	Issues and procedures involved in introducing the litas; separation of BOL; improvements in accounting procedures and controls; preparation of a reporting system for banks; introduction of monetary policy instruments; improvement of prudential banking supervision	Mission	June 92	BOL
MAE	Unification of exchange rates; currency convertibility issues and elimination of exchange controls; development of institutions in the foreign exchange market; operation of the foreign exchange market following the introduction of the litas	Mission	June 92	BOL MOE MOF
STA	Consolidation of general government financial statistics and reconciliation of MOF statistics on government finance with the monetary sector accounts	Mission	June/ July 92	MOF BOL
STA	Follow-up to March 92 mission on price statistics	Consultant's visit	July 92	DOS
STA	Balance of payments statistics	Mission	Sept. 92	MOE DOS

1/ BOL = Bank of Lithuania; DOS = Department of Statistics; MOE = Ministry of Economics; MOF = Ministry of Finance.

Lithuania: World Bank Relations

Lithuania submitted an application to join the World Bank in September 1991 and formally signed a membership agreement on July 6, 1992. An acquaintance mission from the World Bank visited Vilnius from January 19-30, 1992, followed immediately by an infrastructure sector mission from January 30-February 7, 1992 comprising specialists in the areas of energy, environment, municipal services and housing, telecommunications, tourism, and transportation. The reports of these and subsequent missions served as inputs for a first Country Economic Memorandum (CEM), issued in yellow cover on July 6, 1992, which is to serve as the basis for a broad program of lending and economic and sector work.

In view of the immediate need for policy and import support, the World Bank sent missions to Vilnius in March/April 1992 and June/July 1992 to begin arrangements for a fast-disbursing import rehabilitation loan. The negotiations toward a World Bank loan, which were concluded ad referendum in late August 1992, proceeded in close consultation with the negotiations toward an arrangement with the Fund, resulting in a mutually consistent set of macroeconomic and structural policies as described in the Memorandum of Economic Policies. The import rehabilitation loan, which is to be presented for decision to the Executive Board of the World Bank on October 13, 1992, would provide US$60 million, repayable over 17 years with a five-year grace period at the Bank's standard variable interest rate.

Lithuania: Stand-By Arrangement

Attached hereto is a letter and annexed Memorandum of Economic Policies (the "Memorandum") dated September 21, 1992, from the Prime Minister of Lithuania and the Governor of the Bank of Lithuania, as well as a supplementary letter dated September 26, 1992, from the Prime Minister and the Acting Governor of the Bank of Lithuania, requesting a stand-by arrangement and setting forth (i) the objectives and policies that the authorities of Lithuania intend to pursue for the period of this stand-by arrangement; and (ii) understandings of Lithuania with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Lithuania will pursue for the remaining period of this stand-by arrangement.

To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement, in accordance with the following provisions:

1. For the period of 11 months from October __, 1992, Lithuania will have the right to make purchases from the Fund in an amount equivalent to SDR 56,925,000 subject to paragraphs 2, 3, 4, 5, and 6 below, without further review by the Fund.

2. (a) Purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 17,250,000 until February 28, 1993, the equivalent of SDR 30,475,000 until May 31, 1993, and the equivalent of SDR 43,700,000 until August 31, 1993.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Lithuania's currency in the credit tranches beyond 25 percent of quota.

3. Purchases under this stand-by arrangement shall be made from ordinary resources only.

4. Lithuania will not make purchases under this arrangement that would increase the Fund's holdings of its currency in the credit tranches beyond 25 percent of quota:

(a) during any period of the stand-by arrangement while

(1) the limit on contracting or guaranteeing of external government debt of maturities of less than one year (excluding liabilities on the correspondent accounts with FSU countries) referred to in paragraph 64 of the Memorandum; or

(2) the limit on the accumulation by the Government of external payments arrears referred to in paragraph 64 of the Memorandum, is not observed; or

(b) during any period in which the data at the end of the preceding period indicate that

(1) the limit on the cumulative change in total net international reserves referred to in paragraph 63 and Annex IV of the Memorandum; or

(2) the limit on the cumulative change in net international reserves in convertible currencies referred to in paragraph 63 and Annex IV of the Memorandum; or

(3) the limit on the net disbursement of external debt with maturities between 1 and 12 years referred to in paragraph 64 and Annex V of the Memorandum; or

(4) the limit on the net disbursement of external debt with maturities between 1 and 5 years, referred to in paragraph 64 and Annex V of the Memorandum; or

(5) the limit on the cumulative change in net credit from the banking system to the general government referred to in paragraph 28 and Annex I of the Memorandum as modified by the supplementary letter of September 26, 1992; or

(6) the limit on net domestic assets of the banking system referred to in paragraph 35 and Annex II of the Memorandum as modified by the supplementary letter of September 26, 1992, has not been observed; or

(c) after February 27, 1993, until the first review referred to in paragraph 65 of the Memorandum has been completed and appropriate understandings have been reached on suitable criteria for the remainder of the stand-by arrangement; or after such performance criteria have been established, while they are not being observed; or

(d) after May 30, 1993, until the second review referred to in paragraph 65 of the Memorandum has been completed; or

(e) during any period of the stand-by arrangement, if Lithuania

(1) imposes or intensifies restrictions on payments and transfers for current international transactions; or

(2) introduces or modifies multiple currency practices; or

(3) concludes bilateral payments agreements which are inconsistent with Article VIII; or

(4) imposes or intensifies import restrictions for balance of payments reasons.

When Lithuania is prevented from purchasing under this arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Lithuania and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Lithuania will not make purchases under this stand-by arrangement during any period of the arrangement in which it has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase or pursuant to Decision No. 9331-(89/167), as amended.

6. Lithuania's right to engage in the transactions covered by this arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility; or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Lithuania. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 6, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Lithuania and understandings have been reached regarding the circumstances in which such purchases can be resumed.

7. Purchases under this arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Lithuania, the Fund agrees to provide them at the time of the purchase.

8. Lithuania shall pay a charge for this arrangement in accordance with the decisions of the Fund.

9. (a) Lithuania shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those related to repurchase as Lithuania's balance of payments and reserve position improves.

(b) Any reduction in Lithuania's currency held by the Fund shall reduce the amount subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

10. During the period of the stand-by arrangement, Lithuania shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Lithuania or of representatives of Lithuania to the Fund. Lithuania shall provide the Fund,

through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Lithuania in achieving the objectives and policies set forth in the attached letter.

11. In accordance with the authorities' letter, Lithuania will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed, or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Lithuania has outstanding repurchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Lithuania's balance of payments policies.

September 21, 1992

Dear Mr. Camdessus,

The Government of the Republic of Lithuania has started to transform Lithuania into a market economy. To this end, decisive measures have been taken over the course of the past year, including the elimination of price controls for most goods, reform of the ownership of state enterprises and land, maintenance of a prudent fiscal policy, and liberalization of Lithuania's trade and payments system. Moreover, the Bank of Lithuania has taken a number of important steps to prepare itself to conduct monetary policy and exercise prudential supervision following the introduction of a national currency, the litas, which is to be convertible, at least for current international transactions. These reforms have been pursued against a background of sharply contracting output, brought about by trade dislocations with Russia and other trading partners and the move to world market prices for energy and other raw materials.

The Government and the Bank of Lithuania believe that the policies set out in the attached Memorandum of Economic Policies would be adequate to achieve internal and external stability, and to support the continued restructuring of the economy. This will make a key contribution to maintaining confidence in the litas and to creating preconditions for sustained growth over the medium term.

In support of its economic program, the Government hereby requests an eleven-month stand-by arrangement in the amount of SDR 56.9 million. The Government and the Bank of Lithuania will provide the Fund with any information that it may request for the purposes of monitoring progress under the program supported by the stand-by arrangement, and will remain in close consultation with the Fund in accordance with the Fund's policies on such consultations. Furthermore, we stand ready to take any additional measures that may become necessary to achieve the aims of the program.

We will complete with the Fund two reviews of economic developments and policies under the program, the first by February 28, 1993, and the second by May 31, 1993. The quantitative performance criteria for June 30, 1993 will be specified at the time of the first of these reviews.

Sincerely,

/s/ /s/

Aleksandras Abisala
Prime Minister

Vilius Baldisis
Governor, Bank of Lithuania

Attachment: Memorandum of Economic Policies

Michel Camdessus
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431
U.S.A.

September 15, 1992

Lithuania - Memorandum of Economic Policies

I. Introduction

1. Following the occupation of Lithuania by the Soviet Union in the early 1940s, all industrial property and real estate was nationalized, the agricultural sector was collectivized, and a command economy was introduced, leading to a heavily industrialized structure with emphasis on large-scale, highly-specialized enterprises operating under the central planning system. Half a century later, Lithuania has regained its independence. Beginning in September 1991, Lithuania started privatization of enterprises and residences and restitution of the remaining real estate, including land, to the former owners or their descendants. The economy is being transformed into a system of decentralized market-oriented decision making.

2. Yet, the heavy dependence of the Lithuanian economy on the republics of the Commonwealth of Independent States (CIS) as sources of inputs and markets for outputs, as well as continued reliance on the ruble as a medium of exchange, has created severe difficulties for the transformation effort. Political and economic instability within the ruble area, the USSR-imposed economic blockade in the summer of 1990, and the imposition of trade restrictions have resulted in a large cumulative decline in output during recent years. The loss has been compounded since late 1991 by the shift in the prices of oil and other traded goods toward world market levels. This is causing a sharp rise in the average price of our imports relative to the average price of our exports, or a sharp deterioration in our "terms of trade".

3. We have been consulting closely with the International Monetary Fund (IMF), the World Bank, the European Community, and others in designing a strategy for addressing Lithuania's macroeconomic problems and for continuing the transformation toward a market economy. This strategy has at its center a program of economic stabilization designed by the Government. We trust that our demonstrated commitment to create a market-oriented economy and our comprehensive macroeconomic stabilization and reform program will receive timely and adequate financial support from the international community. Such support will allow us to adjust our economy much less abruptly than we would be forced to do without any external financing.

II. The Lithuanian Economy in Early 1992

4. During the first half of 1992, the decline in real gross domestic product (GDP) accelerated, owing primarily to disruptions in trade with the CIS republics and the impact of the sharp deterioration in the terms of trade. It is estimated that real GDP fell more than 30 percent from the beginning of 1990 through mid-1992. Oil imports during the first half of 1992 were about 3.4 million tons (little more than half the capacity of the Mazeikiai refinery), compared with imports of 6 million tons in the first half of 1991. Imports of other energy resources during the first half of 1992 were also much less than the amounts obtained during the first half of 1991. Open unemployment reached 19 thousand workers, or more than 1 percent of the labor force, as of August 1, 1992. Consumer price inflation accelerated to monthly rates around 50 percent during January and February 1992, largely reflecting the price liberalizations and rapid monetary emission in Russia and other parts of the ruble area, and then slowed to about 30 percent in March and an average of about 10 percent from April through June. Beginning in July, inflation has been rekindled by further sharp increases in the prices of imported energy products. Despite these difficulties, the Government has persevered with its efforts to transform the economy, maintaining a prudent fiscal policy, and preparing the institutional framework required for the successful introduction of Lithuania's own currency, the litas.

5. Liberalization of the economy. Although Lithuania won international recognition of its independence only in August 1991, the drive to transform the economy began a year and a half earlier with the election of a new Supreme Council that declared Lithuania's independence in March 1990. Since that time, the Government's strategy has been to create the legal and institutional frameworks required to implement policies of privatization and restitution, establish a market price system, preserve fiscal stability, encourage the development of the financial sector, introduce a system of unemployment support, and initiate various other social and economic reforms.

6. Privatization. The privatization process began in September 1991. The privatization process has been based on a system of vouchers allotted to Lithuanian citizens in amounts based on their age. Lithuanian citizens can buy privatization items for vouchers, rubles, or convertible currency, and non-Lithuanian citizens for convertible currency only. Flats and other dwellings have been appraised and offered for sale to occupants. As of August 21, 1992, 76.1 percent of the total state-owned flats had been privatized. Small enterprises, which are primarily in the services and trade sectors, are being sold at auction. Most small enterprises have already been sold, and it is intended that the privatization of these assets will be completed by the end of 1992. Large enterprises have so far been privatized mainly through a share subscription scheme, in which initial bids are submitted and share prices are then adjusted to balance the supply and demand for shares, but new initiatives are being launched to speed up the process. It is intended to diversify the forms of privatization and to

simplify procedures and eliminate unnecessary restrictions; see paragraph 55. By mid-1992, about 600 large enterprises had been converted into enterprises owned predominately by private shareholders, and there are plans to convert a total of nearly 3500 by the end of 1993; this will leave approximately 350 large enterprises (including power plants, the oil refinery, etc.) under state ownership. In agriculture, it is anticipated that by the end of 1992, 50 percent of all usable land will be privately owned and 80 percent of the total assets from collective farms and state farms will be private property.

7. Prices and wages. Lithuania has taken a series of actions during 1991 and early 1992 to eliminate price controls from most products, and subsidies for food products have been gradually reduced. To maintain budgetary control, most of the higher costs of imported energy products have been passed on to enterprises, and local governments have been encouraged to raise rents and domestic heating charges to reduce the costs to the budget. During the period from the end of 1991 through the beginning of August 1992, the price of energy increased 100 times, and from end-1991 through end-1992 it is estimated that it will have increased 280 times. As of September 1, 1992, the main prices still subject to administrative control were rents, various public utilities charges, transportation fares, fuels, and the prices of certain goods produced or distributed with a high degree of monopoly power. From January 1991 through June 1992, the consumer price index rose about 1700 percent, and the average level of wages increased by roughly the same amount. In this sense, Lithuania maintained a relatively high standard of living in comparison with some neighboring states, although imports and some goods and services that were heavily subsidized in the past became much less affordable. From January 1991 through July 1992, the consumer price index rose about 2200 percent while average wages rose about 1800 percent.

8. Public finance. The consolidated general government budget for 1991 was in surplus by an amount equivalent to nearly 3 percent of GDP. 1/ In nominal terms, the outturns for revenues and expenditures were much higher than originally budgeted, largely reflecting the sharp rise in prices. The surplus also reflected a reduction in subsidies and the positive effects on tax revenues of the increase in profits that resulted from Lithuania liberalizing prices ahead of its major suppliers of imported inputs to production. For the first half of 1992, the authorities maintained a policy of matching spending to available budgetary revenue, and it is estimated that the fiscal outcome was in balance. However, the fiscal situation has become much more difficult with the continuing decline in output and the adverse shift in the external terms of trade.

1/ As defined in detail in Annex I, the consolidated general government budget is the consolidated budget of the state and local governments and all extrabudgetary funds.

9. Monetary policy. Lithuania has not yet been able to conduct an independent monetary policy. Although it would have been possible to introduce the litas earlier, it was decided to delay such action pending (i) the formulation of macroeconomic stabilization policies that can achieve relative stability in the price level, (ii) efforts to agree on arrangements for settling trade and payments with countries that remain in the ruble area, (iii) the accumulation of adequate external reserve assets, and (iv) the separation of the commercial banking operations from the central banking operations of the Bank of Lithuania, along with changes in the organizational structure of the central bank to enable it to perform its monetary policy and prudential supervision functions effectively.

10. The Lithuanian banking system has been substantially reorganized over the past two years. In addition to the central bank, it comprises three state-owned banks--the Savings Bank, the Agricultural Bank, and the State Commercial Bank of Lithuania (in the process of being created)--and about 20 licensed commercial banks. The Savings Bank, the Agriculture Bank, and the Bank of Lithuania have numerous branches throughout the country.

11. From the end of 1990 through the end of June 1992, the rates of growth of broad money and the net domestic assets of the banking system 1/ were about 300 percent and 165 percent, respectively, considerably lower than the rate of consumer price inflation. As a result, the stocks of money and credit have declined considerably in real terms, and the "monetary overhang" that built up when prices were controlled has been substantially reduced or eliminated. By April 1992, shortages of ruble banknotes had created a situation in which the banking system was unable to provide enterprises and the government sufficient cash to pay workers their full salaries, and on May 1 the Bank of Lithuania, in conjunction with a decision by the Government, began issuing talonas (a form of coupons denominated in rubles) to ease the currency shortage. Talonas are provided to banks by the Bank of Lithuania and enter circulation through withdrawals from the bank deposits of enterprises, government agencies, and individuals; they represent legal tender as general substitutes for ruble banknotes in all cash transactions within Lithuania. Interest rates on bank deposits and loans have been increased but remain well below the rate of inflation. Since June, the expansion of credit to the economy has accelerated.

12. External policy. Since regaining independence, Lithuania has taken steps to liberalize its foreign exchange and trade arrangements and to establish independent trade relations with foreign countries, including the

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1/ Broad money is defined as the sum of currency in circulation, including talonas, plus the total deposits of the banking system excluding government and interbank deposits. As defined in detail in Annex II, the net domestic assets of the banking system are defined as net credit to the government plus gross credit to the rest of the economy, plus other items net. Net credit to the government is gross credit to the government minus government deposits in the banking system.

CIS republics. We strongly desire to expand our trade with countries outside the current ruble area and have already signed trade agreements with Sweden and Norway and trade and cooperation agreements with the European Community and many individual countries. At the same time, we recognize that the CIS republics remain our major trading partners, and we attach great importance to improving trade relations with these countries. To this end, Lithuania, Latvia, and Estonia have agreed to form a Baltic Customs Union, and have also proposed a trade arrangement with the CIS republics on a nondiscriminatory basis.

13. In Lithuania, exchange rates for the ruble are market related for most commercial transactions, although a small group of specific enterprises (perhaps 3 percent of all state enterprises) must surrender their foreign exchange earnings to the hard currency fund administered by the Ministry of Finance at an exchange rate less favorable to them than the market level. Foreign exchange to purchase imports, other than essential items financed from the Government's hard currency fund, is provided through the foreign exchange market. Resident enterprises and individuals may hold foreign exchange accounts domestically, and enterprises are not generally prohibited from holding bank accounts abroad.

14. A uniform import and export tax of .01 percent is now assessed for purposes of collecting trade statistics. Except for purposes of national security or health, there are no quantitative restrictions or licensing requirements on imports. Excise duties are levied on exports to the CIS republics of certain raw materials and products, ranging from 20 to 61 percent on leather, timber, and energy products, and up to 92 percent for alcoholic beverages; and for some of these goods, exports to other countries are also subject to excise taxes. For most other goods, an excise duty of 10 percent temporarily applies to products sold or bought for hard currency if international agreements do not specify otherwise.

15. Following the collapse of the centralized system for distributing goods under the Soviet regime, Lithuania has sought bilateral trade agreements with the CIS republics and the other Baltic states as a means of ensuring adequate supplies of material inputs and essential consumer goods. These agreements have been frequently violated by our CIS partners, and resulting shortages of key inputs have idled many factories. For 1992, trade agreements have been signed with all of the CIS republics, but major uncertainties remain about the amounts of oil and other vital imports that we will actually be able to obtain, and about the eventual settlement of trade imbalances. Bilateral trade arrangements for 1992 are also in place with Bulgaria, China, Cuba, the Czech and Slovak Federal Republic, and Hungary.

16. Lithuania's net official international reserves amounted to US$76 million at the end of June 1992. This amount includes 5.1 tons of gold that France and the United Kingdom have returned to Lithuania, which is valued at US$58 million at world market prices. In July, Sweden compensated Lithuania for 1.2 tons of gold, the dollar equivalent of US$14.5 million.

We are conscious of the need to limit external borrowing to a level that can be supported by the economy. Since Lithuania regained its independence, the Government has not accumulated any foreign debt, but in preparation for future borrowing, steps are being taken to centralize the recording and monitoring of external debt. Because Lithuania was an occupied country for the last 50 years, and because Vneshekonombank has appropriated a large amount of Lithuania's foreign exchange reserves, Lithuania does not accept responsibility for any of the external debt of the former Soviet Union. We are prepared, however, to discuss the servicing of US$35.7 million of debts incurred by our enterprises through Vneshekonombank. At the end of 1991, Lithuania owed the Czech and Slovak Federal Republic US$3.2 million under a bilateral clearing arrangement, and agreement has been reached to settle this amount through the export of fertilizer and other products. There were no other outstanding balances at end-1991 on clearing arrangements with states outside the ruble area.

III. The Economic Program through June 1993

17. Program objectives. We are convinced that the major policy changes and measures already undertaken have been in the right direction. In general, they represent a fundamental move away from the command economy system and the beginnings of transformation toward a market economy. We recognize, nevertheless, that many additional actions are necessary to stabilize the economy and ensure a successful transformation, as well as to obtain the external financing that will help ensure this success. The Government is committed, therefore, to pressing ahead speedily with a further strong program of reform and stabilization.

18. The main objectives of Lithuania's economic program for July 1992 through June 1993 are to adjust quickly to the sharp deterioration in the terms of trade, to continue to encourage an effective private market economy, to limit the effects on output arising from both the shift in the terms of trade and the process of economic transformation itself, to successfully introduce the litas and achieve a sharp reduction in inflation, and to ensure social guarantees consistent with the economic situation in Lithuania. The program sets targets for building up foreign exchange reserves to instill confidence in the new currency, and for limiting the deficit in our international balance of payments. We are seeking to obtain the external financing implied by these targets, which is considered to be an amount consistent with the economy's longer term debt-servicing capacity.

19. To achieve the objectives we have set, including the successful introduction of the litas, the program comprises: (i) further steps to reduce subsidies and make the price system more effective; (ii) improved mechanisms for directing social benefits to the most vulnerable groups of the population; (iii) various fiscal reforms aimed at strengthening budgetary control; (iv) measures to strengthen the banking system and enable the Bank of Lithuania to control the supplies of money and credit effectively; (v) a temporary incomes policy consistent with adjusting real

incomes to the deterioration in the terms of trade, and then bringing inflation down sharply; (vi) the continuation of convertibility for at least current international transactions after the litas is introduced, together with further liberalization of the exchange and trade systems; and (vii) a number of other important structural measures to develop stronger competition in the economy, to speed up the processes of privatization and land reform, to strengthen managerial incentives and begin to address the problems of large enterprises that require restructuring, and to continue reducing the scope of direct government involvement in the economy. The program also includes various steps to strengthen the statistical infrastructure and institutional framework for implementing economic policy, monitoring economic developments, and evaluating and coordinating necessary policy adjustments in a timely manner.

20. Pricing policy and inflation. Although most prices have already been decontrolled, the Government recognizes the importance of proceeding quickly to eliminate as many of the remaining price subsidies as possible. The early elimination of subsidies is important for reducing strains on the budget and for incurring the associated price rises in advance of the introduction of the litas, so as to create the best possible conditions for price stability thereafter. Furthermore, the increase in prices for energy and other products with a high import content will encourage conservation in the consumption of such products by households and enterprises, which is essential for reducing imports of these products to adjust Lithuania's balance of payments.

21. Our policy for pricing energy products distinguishes between those products that it is appropriate to produce and distribute under a concentrated industrial structure--specifically, gas, heat, and electricity--and those products for which it is appropriate to let prices eventually be determined by market forces. For the latter products, consumer prices are already being adjusted, and will continue to be adjusted as needed in the future, to cover the full costs of imports, production, and distribution, plus depreciation and a reasonable profit margin. Furthermore, to strengthen market forces, all controls on the prices charged for these products will be removed by January 1, 1993, except in any cases where regulation remains necessary because of monopolistic price setting. For gas, heat, and electricity, average prices (averaged across different groups of users and different times of day) are also being adjusted in stages, and will continue to be adjusted as necessary, to cover full costs (as defined above); this requires marking up the prices charged to enterprises to cover any subsidies on household use. The prices of gas, heat, and electricity will continue to be regulated since producers are natural monopolies. By March 1, 1993, an energy saving program will be adopted. Several stages of this program are being implemented even now. The program will involve installing utility meters to measure the consumption of energy and, during 1993, any subsidies on household use of gas, heat, and electricity will be gradually phased out. Price controls have already been removed on all goods and services other than energy products, except for a small number (primarily rents and other municipal services, utility services,

communications, public transportation, and some alcoholic beverages and tobacco products) that can be justified on the basis of monopolistic conditions or on social grounds. The Government has liberalized all procurement prices paid to farmers and will not reintroduce price controls on agricultural products. The general government budget for the second half of 1992 includes agricultural subsidies of rub 1.2 billion, partly in response to difficulties created by the recent drought. The Government intends to limit agricultural subsidies to amounts that can be accommodated within the government budget. In July of the current year it appealed to Governments in other countries to assist in cushioning the consequences of the drought.

22. The authorities intend to make the price system more effective by moving ahead quickly with anti-monopoly legislation and other measures to develop stronger competition in both production and distribution, as discussed in paragraph 54.

23. As a result of the continuing rise in prices paid for energy and other imports, which were close to full world market levels by September 1, 1992, the authorities expect that the overall consumer price index for Lithuania will rise about 100 percent in August and September combined, following the 27 percent increase in July. However, following the pass through of higher energy prices, and with the introduction of the litas and the consistent implementation of firm fiscal, monetary, and incomes policies under our economic program, the rate of inflation should decline rapidly thereafter, falling well into single digits by December 1992, and to about 2 percent per month by the end of the first quarter of 1993.

24. Fiscal and monetary policies. A successful economic transition requires a stable economic environment created by sound macroeconomic policies. To that end, we intend to hold general government spending in line with revenues, and to ensure that money and credit expansion does not endanger macroeconomic stability.

25. With regard to fiscal policy, the target for the remainder of 1992 is for balance in the general government budget. This will require a combination of changes in government spending and tax policies. To help constrain spending, subsidies will be reduced substantially by adhering to the pricing policy described in paragraphs 20-22, and efforts will be made to hold down the costs of the social safety net in accordance with the state of the Lithuanian economy, as described in paragraph 53. The wages of workers in budgetary institutions will be frozen for two months beginning on September 1, 1992, and thereafter wage increases for these institutions will be kept consistent with achieving the target rate of price inflation under the program, in line with the incomes policy described in paragraphs 41-42. The increase in consolidated general government expenditure on goods and services will be further restrained to well below the inflation rate.

26. To provide additional revenues during the second half of 1992, the value-added tax rate was increased to 18 percent beginning July 1, 1992, and

a number of other actions have been or will soon be taken. These actions include: (1) abolishing the authority of local governments to grant tax reductions, exemptions, and subsidies (except for those taxes and charges levied by local governments and for which local governments receive all the revenue); (2) raising excise taxes on alcoholic beverages to an average ad valorem rate of about 63 percent and on tobacco to more than 50 percent; and (3) converting the specific excise taxes on petroleum products to ad valorem taxes and setting the tax rates between 7 and 30 percent of the final price to the consumer, still well below the average international tax rate of 60 to 90 percent on petroleum products. If necessary, the Government is ready to take additional measures to ensure the achievement of a balanced budget for the rest of 1992. To help maintain budgetary control, no additional extrabudgetary government funds will be created. 1/ Borrowing by local authorities will not be permitted without prior approval by the central government to ensure that such borrowing is consistent with the performance criteria specified for the program. The Government will limit its own expenditure commitments to the budgetary revenues available. In addition, by January 1, 1993 the Government will review civil service staffing and remuneration policy with a view to developing a program and timetable for eliminating jobs that are no longer necessary in institutions financed from the general government budget.

27. During the remainder of 1992 and the first half of 1993, the Government will continue to aim at balance in the general government budget, and will place very high priority on actions to strengthen expenditure control, tax administration, and budgetary planning. To this end, technical assistance will be requested from the IMF, or from other sources in consultation with the IMF. By February 1, 1993 we will (1) take steps to establish within the Ministry of Finance a new system of budget and expenditure control, (2) take steps to improve the design and administration of the general excise tax to make it a full-fledged value-added tax, and (3) prepare to introduce a budget presentation of the consolidated general government based on the methods of accounts of the IMF's Government Finance Statistics. The Public Finance Working Group will be made fully operational to begin budgetary projections in linkage with other macroeconomic variables and policies, to formulate alternative fiscal policies, and to monitor the execution of the fiscal program. We also recognize the need to simplify and harmonize our tax systems. To this end, by the middle of 1993 we will act to: (1) simplify the enterprise profit tax system by setting a uniform tax rate for all enterprises; (2) simplify the personal income tax system by providing the same amount of tax credit for all tax payers, by taxing wages and salaries on a uniform basis but with a progressive tax rate schedule, and also taxing nonwage incomes on a uniform basis; and (3) equalize the enterprise profit tax rate and the top marginal rate of personal income tax.

1/ This does not prohibit charity funds to which money is contributed voluntarily.

28. Quantitative ceilings will be set for net credit to the general government from the banking system. These ceilings will confine such credit during the program period to smoothing seasonal shortfalls in budgetary revenues relative to expenditures. Taking account of seasonal factors, the net deposits of the general government in the banking system, which are estimated to have been rub 4,700 million as of June 30, 1992, shall not fall below the litas equivalent of rub 4,700 million as of December 31, 1992 nor fall below the litas equivalent of rub 4,000 million as of March 31, 1993. As detailed in Annex I, these limits do not include any disbursements of foreign loans, and they may require adjustment to allow for the use of government deposits in the financial restructuring of the Savings Bank.

29. Looking further ahead, the Government is committed to support structural fiscal reforms aiming at keeping the evolution of public expenditure in the medium term in line with the evolution of tax revenues plus noninflationary (non-bank) financing. One medium-term objective will be to strengthen the tax system to make it more elastic and efficient. A second objective will be to strengthen public expenditure management, including the processes of planning, formulating, and executing the budget. The Government also recognizes that local authorities must be able to plan investments and other expenditures on the basis of projected revenues and, accordingly, will act over the medium term to complete the set of rules specifying the shares of various tax revenues that are to be allocated to local authorities.

30. The Government recognizes that some of the banking system's outstanding loans to state enterprises will have to be covered. The authorities will seek to obtain technical assistance from the World Bank to plan the financial restructuring of the banking system (that is, to address the problem of bad loans), as discussed further in paragraph 39. Implementing the plan may require substantial budgetary outlays in the years ahead. Accordingly, the Government will consider setting aside revenues from privatization sales for this purpose, and, if necessary, will allocate additional funds in the budget.

31. With regard to <u>currency reform and monetary policy</u>, the Government and the Bank of Lithuania, in close cooperation with the IMF staff and with other organizations, intend to introduce the litas prior to, or at the start of, the requested financial assistance program, and in a manner consistent with the recommendations of the IMF technical assistance report on issues in introducing a national currency in Lithuania. The authorities accept the principle that the ruble bank notes withdrawn from circulation should be held by the Bank of Lithuania pending the results of negotiations with the authorities of Russia. Such negotiations should recognize that stocks of ruble banknotes obtained by Lithuania have been "purchased" through debits to Lithuania's correspondent accounts in Moscow. The authorities are seeking to agree with major trading partners in the ruble area on more effective arrangements for settling trade.

32. A two-tier banking system is essential for effective monetary policy and the successful introduction of the litas. Accordingly, we have taken action, in close consultation with technical assistance missions from the IMF, to separate the commercial banking operations from the Bank of Lithuania, and to ensure that the new organizational structure of the central bank will enable it to perform its monetary policy and prudential supervision functions effectively. This will result in the creation of a new state-owned bank, the State Commercial Bank of Lithuania. The preparation of a balance sheet for the central bank has been completed, and such balance sheets showing end-of-month data will be made available no later than two weeks after the end of each month.

33. Until the introduction of our own currency, the issuance and use of talonas (coupons) will be controlled in such a manner that, as long as the ruble is circulating in Lithuania, rubles will not be discriminated against relative to talonas.

34. Following the introduction of the litas, monetary policy will be formulated with a view to providing domestic credit at a rate that is consistent with expected economic activity and a target path for inflation.

35. As detailed in Annexes II and III, quantitative ceilings will be set for the net domestic assets of the banking system, along with a consistent indicative limit for the net domestic assets of the central bank. It is the intention to move in the future to performance criteria for the net domestic assets of the central bank rather than the net domestic assets of the banking system. The net domestic assets of the banking system are estimated to have reached rub 30,900 million on June 30, 1992. The net domestic assets of the banking system should not exceed the litas equivalent of rub 80,000 million as of December 31, 1992, nor exceed the litas equivalent of rub 87,500 million as of March 31, 1993.

36. The ceiling on the expansion of net domestic assets of the banking system will be supported by a system of bank-by-bank credit limits. For the six months ending December 31, 1992, the credit limits for individual banks will be distributed in proportion to the shares of individual banks in total net domestic credit as of June 30, 1992. In distributing the credit limits among individual banks, part of the overall credit limit will be used to provide scope for new banks to form. The credit limits for individual banks will be set on net domestic credit expansion excluding changes in net credit to other banks. This will allow banks to increase their deposits by more than their credit limits, and to lend the excess to other banks. Banks that violate their credit limits will be penalized by being required to increase their reserve holdings at the Bank of Lithuania, which will not earn interest, by 100 percent of the excess credit granted. Beginning with the three-month period ending June 30, 1993, the proportions in which the limits on net domestic credit expansion are allocated among individual banks will be adjusted from the proportions allocated during the previous quarter, taking into account the shares of individual banks in the growth of the total deposits of the banking system.

37. The Bank of Lithuania will continue to impose reserve requirements on banks in proportion to the amount of their deposit liabilities. The minimum reserve ratio is currently 10 percent and will be adjusted by the Bank of Lithuania when appropriate to control credit expansion. For the time being, until its income position is strengthened and the monetary system has developed further, the Bank of Lithuania will not pay interest on either required reserve holdings or reserve holdings in excess of the minimum requirements. A refinancing facility will be established to enable the Bank of Lithuania to provide credit to individual banks, subject to the indicative limit on total net credit provided by the Bank, and the interest rate charged on refinancing credit will be determined by auctioning the credit. To make this system effective, the practice of granting credit through automatic overdrafts on the correspondent accounts of banks at the Bank of Lithuania will be terminated. The central bank will also introduce a second facility through which a bank could borrow to meet its reserve requirements, but at an interest rate set at a level higher than bank lending rates--and significantly higher than the target rate of inflation under the program--to discourage banks from using this facility. 1/ It is expected that the interest rate on the central bank credit that is auctioned will also exceed the target rate of inflation.

38. Eventually, interest rates will become the main instrument for the allocation of financial resources in the economy. In the meantime, the Bank of Lithuania will refrain from providing interest rate subsidies. The interest rates of commercial and state-owned banks will be liberalized, although the central bank will guard against potential problems by remaining watchful of the difference between lending and deposit rates and exercising prudential supervision of banks to discourage excessive risk taking. To facilitate the eventual transition to indirect monetary control, the authorities plan to seek technical assistance from the IMF or other sources during the first half of 1993 to develop a market in Government securities.

39. The Bank of Lithuania recognizes its responsibilities as lender-of-last resort within Lithuania. It will seek technical assistance in establishing accounting, auditing, and payments systems that conform to international standards, in developing an effective system of bank supervision and regulation, and in modernizing the domestic payments and clearing system. Work has been started on procedures and reporting requirements for off-site banking supervision, in consultation with experts of the IMF and other organizations. By the end of 1992, a new reporting system for commercial and state-owned banks will be made operational to facilitate off-site banking supervision, and a new plan of accounts for the Bank of Lithuania will be implemented to facilitate monetary analysis. By early 1993, enabling regulations will be in place for the introduction of accounting, auditing, and payments systems conforming to international standards; this

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1/ A mission from the Monetary and Exchange Affairs Department of the IMF presented detailed recommendations for establishing these two facilities to the Bank of Lithuania during a visit to Vilnius in June 1992.

will be followed with training programs and institutional arrangements necessary to implement these systems and to start implementing on-site banking supervision procedures. Also by early 1993, a detailed plan and timetable will be developed for modernizing the domestic payments and clearing system. In addition, as mentioned in paragraph 30, the authorities will coordinate with the World Bank in seeking technical assistance to plan the financial restructuring of the banking system, which may require resources from the budget. Various approaches will be examined, including the creation of a special government agency to take over the non-performing assets of the banking system, with the intention of completing a study and formulating a coherent plan by February 1, 1993. The study will consider the implications of the different approaches for the budget, the banking system, and the privatization program. It will also identify ways of adapting the banking system to the needs of a market economy and, in particular, increasing private ownership of banks.

40. The strength and effectiveness of our monetary and banking system will have a major influence on Lithuania's economic growth and prosperity, and we intend to complete a comprehensive review of our banking laws, in consultation with the IMF staff and other organizations, with the aim of taking appropriate steps by March 1, 1993 to strengthen this system of legislation. In the meantime, we have acted to ensure that the system of banking laws empowers the Bank of Lithuania (i) to establish interest rate policy for all banks, and to be the only authority so empowered: (ii) to be the Government's primary depository; (iii) to manage Lithuania's official international reserves, including its gold; (iv) to prudentially supervise banks, including their foreign exchange operations; and (v) to be responsible for distributing and managing Government securities. To this end, we have rescinded the Government's authority to determine interest rate policy.

41. Incomes policy. The Government is committed to the liberalization of wages and has legalized collective bargaining at enterprises that are not financed directly from the budget. Nevertheless, given that the adverse shift in the external terms of trade implies an unavoidable loss of real purchasing power for the country as a whole, and that Lithuania has been experiencing a wage and price spiral that we want to bring down sharply following the introduction of the litas, the Government is also of the view that the success of its stabilization effort hinges critically on introducing a temporary incomes policy. Such a policy is intended initially to hold down the increase in wages relative to the rise in prices in order to prevent the shift in the external terms of trade from leading to an excessive fall in output and employment. Subsequent to adjusting to the shift in the terms of trade, the incomes policy is intended to establish guidelines for restraining the rise in nominal wages to a rate consistent with the target for price inflation. Such wage restraint will limit the increase in costs of production and, in combination with tight monetary and fiscal policies, will thereby make the inflation target achievable. It is intended that this policy will not reduce the real purchasing power of wages any more than is necessary to adjust to the shift in the terms of trade.

The need for such a policy after adjustment to the terms of trade shift reflects the fact that, even when credit is tightly constrained, managers of state enterprises--which continue to account for a substantial share of economic activity in Lithuania--may not face sufficiently strong financial constraints to be able to resist their employees' wage demands. This situation will change over time as a result of the many structural reforms we are undertaking, and we plan to review the need for an incomes policy at the end of the program period.

42. Under the incomes policy each enterprise and organization will be asked to keep the percentage increase in its average wage below a certain uniform wage guideline during each specified period. For this purpose, wages will be measured to include all remuneration to workers and managers, including any bonuses or premiums paid out of profits and any expenditures on nonwage benefits for the employed (other than health benefits and professional training). Each enterprise or organization will remain free to reward individual workers on the basis of relative productivity, merit, and market value; the guidelines will apply only to the percentage increase in the average wage of the enterprise or organization. The Government will secure the legal authority from the Supreme Council to control wages directly in state enterprises. This authority would be used, if necessary, to ensure compliance with the wage guidelines. The incomes policy will be reviewed with the IMF during the reviews of the program in February 1993 and May 1993. Although a system of direct wage controls would not apply to the private sector, it can be expected that enforcement of the wage guidelines for the state sector would have a major influence on wages in the private sector as well. Details of the incomes policy measures, which will also cover the minimum wage rate, are described in Annex VI.

43. External sector policies. The Government recognizes that, in the transition to a market economy, the removal of exchange and trade restrictions is a central part of the strategy for introducing a rational structure of relative prices, for exposing domestic monopolies to competition, and for alleviating supply bottlenecks. These measures work together with price liberalization and privatization to create a competitive environment and establish appropriate market signals to guide production and investment choices by decentralized decision makers.

44. From the time of the introduction of the new currency, Lithuania will adopt a unified exchange rate applying to both current and capital transactions. All official buying and selling rates for enterprises will be replaced by market rates established at the banks that are licensed to buy and sell foreign exchange. In this connection, the Government's extrabudgetary foreign currency funds will be abolished with or before the introduction of the litas, and the Government will purchase and sell foreign exchange at the prevailing market exchange rate. The unification of exchange rates will also require that various taxes related to foreign exchange transactions, or paid in foreign currencies, be eliminated or replaced by appropriate domestic taxes. To this end, the 5 percent tax on foreign exchange transactions has already been abolished, and taxes paid in

hard currency--including a portion of the profit tax and various excise taxes--have been or will be replaced by taxes payable in domestic currency that do not discriminate between domestic and foreign sales after introduction of the litas. The special exchange rates for sales of property and equity shares to Lithuanian expatriates will be replaced by equivalent taxes on sales of assets to expatriates. Any negative effects on fiscal revenues resulting from the above measures could be offset by introducing low and relatively uniform tariff rates on imports.

45. Concurrent with the introduction of the litas, the Bank of Lithuania will establish a new foreign exchange regime consistent with a high degree of convertibility of the litas at market-determined exchange rates. Our goal is to make the litas convertible for all international transactions. To this end, we will ensure that residents continue to be allowed to purchase foreign exchange in the market for purposes of making payments for all bona fide current international transactions. Recognizing the importance of attracting inflows of foreign capital and establishing a secure environment for investment, we will also ensure that nonresidents continue to be allowed to purchase foreign exchange in the market for purposes of repatriating their earnings (after paying domestic taxes) and their capital. Any restrictions on other capital account transactions will be kept to a minimum and lifted as our external reserve position strengthens.

46. With the introduction of the litas, a floating exchange rate regime will be established and the value of the litas will be determined in the market established by the banks that are licensed to deal in foreign exchange. With technical assistance from the IMF and other sources, the Bank of Lithuania is taking steps to deepen and broaden the institutional arrangements required for the smooth and efficient functioning of foreign exchange markets. The Bank and Government are also committed to the pursuit of sound monetary and fiscal policies to ensure the stability of the litas and enable us to consider the adoption of a fixed exchange rate system once the litas has demonstrated its stability and Lithuania has built up adequate foreign exchange reserves.

47. Households and enterprises will be allowed to continue to hold their savings in foreign currency deposits with the domestic banking system. If it is decided in the future to impose a requirement that export earnings be sold to the Lithuanian authorities, such a surrender requirement would only be at a market-determined exchange rate. For prudential purposes, the foreign currency exposure of domestic banks will be limited. In particular, banks will be expected to maintain approximate balance between their foreign currency liabilities and their foreign currency assets, thereby holding down their exposure to large valuation losses that could result from changes in exchange rates. To this end, by October 1, 1992 the Bank of Lithuania will establish prudential monitoring and standards for foreign currency exposure of domestic banks. These standards will apply to exposure in each foreign currency.

48. Lithuania does not currently impose quotas or licensing requirements for imports, and will not introduce quantitative restrictions on imports except for purposes of national security or health. We intend to remove all quotas and licensing requirements for exports by November 1, 1992, with the exception of those applying to certain energy products and timber of local origin, and to remove all remaining quantitative restrictions by January 1, 1993, except those restrictions on exports of products subject to quantitative import restrictions in the country of destination or to administered prices, or restrictions deemed by the Government to be necessary for reasons of security or health. For the limited number of products that require export restrictions in association with controls on prices, export taxes will be imposed instead of quotas whenever possible. Other trade-related taxes will be reviewed and simplified by the end of 1992, including excise tax rates that depend on whether products are sold domestically or exported. In any event, in compliance with its international responsibilities as a member of the IMF, the Lithuanian authorities do not intend to introduce or intensify restrictions on payments and transfers for current international transactions, to introduce or intensify import restrictions for balance of payments purposes, 1/ or to introduce or modify multiple currency practices. Moreover, the Lithuanian authorities do not intend to accumulate external payments arrears.

49. The Government is committed to removing remaining interstate trade barriers, promoting direct trading between enterprises, and reducing the direct involvement of the Government in trade relations. During the period of the program, the Government will not conclude new bilateral payments agreements inconsistent with Article VIII of the IMF's Articles of Agreement. The Government intends to conduct Lithuania's international economic relations on a nondiscriminatory basis in line with multilateral trading principles prevailing in the world economy. In this context, the Government recognizes the need for continued close economic relations with the CIS republics, as well as the need to integrate its economy into the world trading system. It is committed to fostering cooperative relationships in all areas of interstate and foreign economic and financial relations, and to avoid actions that would disrupt trade. To that end, the trade initiatives mentioned in paragraph 12 are being seriously pursued, and we plan to prepare an action plan for implementing the Baltic free trade agreement, in cooperation with Estonia and Latvia, and in the context of Lithuania's general future trade relations and tariff regime. Over the medium term, Lithuania intends to develop a rational tariff structure with low and relatively uniform tariff rates that are in accordance with internationally accepted principles.

50. It is clear, however, that interstate cooperation cannot be achieved by Lithuania acting alone. It also requires equivalent actions by others. We note that part of the IMF's mandate is to assist countries so that they do

1/ This does not preclude the introduction of relatively uniform import tariffs to raise fiscal revenues.

not resort to measures destructive of international prosperity. We understand that the IMF will seek to work closely with Lithuania and all other member countries of the IMF to facilitate the development of cooperative agreements and relationships.

51. Structural policies. Extensive structural changes are necessary to generate an efficient supply response to macroeconomic management, to strengthen incentives for microeconomic units to invest in the economy and engage in productive activities, and to provide a system of social benefits that protects the population against economic hardship. Many types of structural reforms are needed to accomplish our objectives, and the faster these can be undertaken, the sooner the economic system will be strengthened and growth resumed. The Government has been involved in extensive discussions with the World Bank and IMF staff on structural adjustment measures relating to the social safety net, anti-monopoly policy, privatization, the legal and institutional framework for commercial activity, enterprise reforms, financial restructuring of the banking system, economic management, and regional economic policy.

52. Social safety net. We are committed to the protection of the most vulnerable groups of the population by providing social benefits to eligible individuals and families. This will require various types of programs, both to address the emerging problem of unemployment and to target the provision of social benefits to the groups that most need them.

53. The current system of social benefits is broadly based and requires reform. We intend to count on technical assistance from the World Bank or other international institutions in restructuring the social safety net, and will remain in close consultation with IMF staff on matters relating to the financing of the social benefit system and the degree to which benefit levels are indexed to wage or price levels. To keep expenditures consistent with budgetary resources, the following transitory and extraordinary measures will be prepared by November 1, 1992 for quick introduction in case of necessity: (i) a simplified (possibly flat rate) structure of unemployment benefits, along with appropriately modified eligibility criteria; and (ii) a simplified flat-rate structure of pension benefits. The Government also intends: (iii) to review and, as unemployment projections require, strengthen the staffing and equipment of local employment offices; (iv) by January 1, 1993 to define a minimum poverty line (linked to an index of prices for a basic subsistence-level consumption basket) which will form the basis for developing recommendations for a viable social assistance program and identifying and initiating necessary legislative changes; (v) by January 1, 1993 to determine the general priorities and develop a plan for the medium-term design and financing of the social safety net system (pensions, unemployment benefits, family benefits, sick pay benefits, social assistance benefits) including, in particular, a comprehensive pension reform plan based on a full costing of alternative options and an evaluation of options for establishing private pension schemes within an appropriate legal framework; (vi) by January 1, 1993 to design and start implementing a system of retraining and other

active labor market policies, with a specified level of financing; (vii) by January 1, 1993 to take the steps necessary to strengthen the staffing and equipment of the network of local social assistance offices; and (viii) by early 1993 to design and start implementing an effective means-testing system for channeling social benefits to the most vulnerable groups of the population, with the objective that the system be fully operational in the second half of 1993.

54. Anti-monopoly policy. The Government intends to give special attention to developing stronger competition in the economy, both in production and distribution. This will involve a combination of measures. Actions have been taken to remove legal barriers to starting new businesses, to eliminate restrictive licensing requirements for production and distribution, to permit trading by distributors without geographical restrictions, and to begin the splitting up of multi-plant enterprises. Rational actions to break up large enterprises are to continue, both on a case-by-case basis under the aegis of the relevant branch ministries and in conjunction with the privatization program. A law defining unfair competition and monopoly practices, and identifying penalties for such behavior, has been submitted to Parliament; and technical assistance has been requested for the further development of accompanying regulations and the evaluation of alternative institutional arrangements to implement and enforce the law. In this regard, our intention is to have appropriate regulations and institutional arrangements in place by the beginning of 1993. As additional actions to promote new private investment and commercial activity, a decree has recently been issued requiring the contracting out of public services, and we intend to intensify our ongoing efforts to disseminate information systematically about relevant legislation, regulations, and sources of external and domestic assistance.

55. Privatization. As already noted, it is our intention to proceed with the privatization of state enterprises as quickly as possible, as well as with the restitution of property. We intend to take measures to remain on schedule in privatizing almost all eligible housing and small enterprises by the end of 1992. In this regard, for those enterprises that were not sold the first time they were put up for auction, we have reduced restrictions on the amounts of vouchers and cash that citizens can use as means of payment in subsequent auctions. Moreover, we intend to remove cash-quota restrictions for auctions of all enterprises as soon as the litas is introduced. Other new initiatives are also being launched to speed up the privatization of large enterprises and we have submitted to Parliament amendments to the law on privatization that would enable liberalization and simplification of the privatization process. Most restrictions on privatization to foreign investors were eased in June 1992, except for a small list of reserved activities, and a diagnostic study is being undertaken to assist in designing more ways to promote foreign private investment. Based on this study, we intend to prepare further amendments to remedy deficiencies in the foreign investment law, and accordingly to modify procedures for foreign investment by April 1, 1993. Additional initiatives to encourage privatization of large enterprises include: the systematic

break-up, where feasible, of such enterprises into small units that are easier to sell, according to guidelines issued earlier this year; and the introduction of a wider variety of privatization techniques. In connection with the latter initiative, by November 1, 1992 we intend to prepare, with World Bank assistance, a specific plan of action for undertaking demonstration privatizations using a number of additional techniques.

56. The framework for commercial activity. To further strengthen the legal and institutional framework for commercial activity, a bankruptcy law--drafted with input from OECD experts--has been submitted to Parliament. Efforts are being made to develop accompanying regulations and strengthen the juridical infrastructure necessary to enforce the law, with the objective of making bankruptcy proceedings operational as soon as possible. To eliminate obstacles to commercial activities, restrictions on leasing land and renting business premises are being removed, and we will seek to remove the remaining restrictions on land sales by mid-1993. We also intend by mid-1993 to undertake a comprehensive review of all major laws governing transactions (such as laws governing transfers of property and sales, credit, and collateral) with the intention of elaborating and modifying this legislation as appropriate.

57. Enterprise reforms. The Government has been undertaking initiatives, in addition to the privatization program, to create independent commercially-oriented entities from previous state-owned conglomerates and large enterprises. Such enterprises were made independent of their founding ministries by early 1992, with complete financial autonomy, and all direct subsidies for current expenditures from the state budget to enterprises have been discontinued. As further action, we intend to complete a study by the end of 1992, with World Bank assistance, to re-examine the present organizational arrangements for state-enterprise management and make plans for modifications which would facilitate improved performance. Initiatives are also being undertaken to strengthen financial accounting. The Parliament has passed a law on new accounting procedures meeting internationally accepted standards; regulations and accompanying institutional arrangements to implement these accounting procedures are to be prepared by the end of 1992; and training is to be provided with the aim of making the new procedures fully operational during 1993. In addition, we intend to design and make operational by the beginning of 1993 an effective system for reporting the financial flows of enterprises.

58. While we recognize that the production structure built up under the Soviet regime will have to be substantially changed over time, we attach great importance to insuring that adjustments on the supply side of the economy proceed in an orderly way. Because many state enterprises currently employ large numbers of workers and labor mobility is low, the financial constraints on state enterprises cannot be tightened abruptly without risking unacceptably high output losses and social costs. At the same time, we recognize that failure to tighten the financial constraints on enterprises could undermine the stabilization effort and the process of transforming the economy if it led to fiscal spending in excess of revenues

or to excessive domestic credit expansion. Accordingly, to help address the difficulties that will arise, we intend by early 1993, and with assistance from the World Bank, to begin to undertake thorough studies of selected sectors and large enterprises in order to identify their medium-term restructuring needs, with emphasis on Lithuania's potential to expand production of exportable goods and services.

59. Economic management. The Government recognizes that there are weaknesses in the present statistical infrastructure and institutional framework for monitoring economic developments and evaluating and coordinating policy. High priority must be given to implementing mechanisms for data collection and compilation--and to providing adequate staffing and training in our ministries and central bank--so that national accounts, price, monetary, fiscal, and balance of payments statistics become available on a timely basis. To this end a Statistics Law to clarify responsibilities for data compilation and provide the necessary legal authority for data collection will be prepared and passed as soon as possible. We have completed the work necessary to reconcile the recording of general government financial statistics by the Ministry of Finance with the statistics reported by the banking system. In addition, by November 1, 1992 we will establish a system for monitoring, recording, processing, and managing external debt flows, consistent with the reporting requirements of the World Bank, with all inflows of foreign grants and government borrowing centralized through the accounts of the Ministry of Finance. In taking measures to improve our statistics, we are drawing on the technical assistance we have already received from the IMF, and, where necessary, we will continue to seek appropriate technical assistance in this area. Serious efforts will also be made to strengthen the institutional framework for policy development and the mechanisms for coordination among the various economic ministries and the Bank of Lithuania. To this end, a committee consisting of representatives of the Ministry of Economy, the Ministry of Finance, the Ministry of International Economic Relations, the Ministry of Foreign Affairs, the Bank of Lithuania, and the Resident Representative of the IMF, will closely monitor progress under this program and report directly to the Prime Minister.

60. By early 1993, in anticipation of a resumed public investment program, we will establish a mechanism to set priorities, establish project evaluation criteria, and appraise projects proposed for public investment. By mid-1993, we will prepare the first version of a rolling three-year public investment program.

61. Regional economic policy. The Government will endeavor to develop the basis for prompt implementation of regional economic development programs and promotion of traditional and locally-based entrepreneurship activities. To this end municipal property will be founded, stable municipal budget income sources will be defined in terms of objective principles, and the rights of local municipalities will be established and their functions segregated. In addition, to create more favorable conditions for entrepreneurship in Lithuania and to improve the efficiency of government

management, vocational training programs will be implemented for governmental and municipal staff, and their rights and responsibilities will be defined. Measures will also be taken to eliminate both the possibility for persons to abuse powers pertaining to their positions and any delays in decision making procedures.

62. Balance of payments prospects and financing. Over the medium term, we expect exports to strengthen substantially in response to the structural changes in production and the strong competitive position that the Government intends to maintain. In the short run, however, the balance of external payments will deteriorate owing to the initial adverse impact of structural adjustment and the worsening in the terms of trade, and to the very severe drought that has been experienced during 1992. The current account deficit is targeted at close to US$500 million for the program year. Part of this deficit will be offset by private capital flows (mainly through direct investment). The remaining gap is expected to be financed by official balance of payments support, including support from the IMF, World Bank, EBRD, and bilateral creditors. A substantial portion of such assistance, including virtually all support from the IMF, is intended to permit a buildup of gross official international reserves, to US$120 million by the end of June 1993.

63. We have established targets for changes in net international reserves, as defined in Annex IV. Net official international reserves in convertible currencies amounted to US$76 million on June 30, 1992. Including the deficit in the correspondent accounts with the CIS republics, total official reserves stood at US$25 million. The fall in net official international reserves in convertible currencies that takes into account the repatriation of the equivalent of gold of US$14 million shall not exceed US$10 million during the six months ending December 31, 1992. With a targeted reduction in the deficit in the correspondent accounts of US$10 million, there shall be no fall in total net international reserves during this period. During the nine months ending March 31, 1993 there shall be a cumulative reduction in the deficit in the correspondent accounts of US$25 million, while the fall in net international reserves in convertible currencies shall be limited to US$10 million. As a result, total net international reserves shall increase by not less than US$15 million during this period. The targeted reduction in the deficit in the correspondent accounts assumes that at least some of the net arrears owed to Lithuanian enterprises by enterprises in the CIS republics will be offset against imbalances in the correspondent accounts. The cumulative change in total net international reserves for the period ending March 31, 1993 shall be adjusted at the time of the first review of the program depending on the outcome of the negotiations between the Lithuanian Government and the CIS republics.

64. External borrowing contracted or guaranteed by the Government or the Bank of Lithuania or other agencies on behalf of the Government (excluding proceeds of purchases from the IMF) will be held below a ceiling of US$150 million, through December 31, 1992 and below a ceiling of US$350 million through March 31, 1993. Consistent with this target, the

authorities will not contract or guarantee external debts with maturities of less than one year, with the exception of normal import-related credits, and net disbursements of external debts with maturities between 1 and 5 years, will be held below ceilings of US$50 million through December 31, 1992 and US$125 million through March 31, 1993. Details are set out in Annex V. In addition, compliance with the obligation not to accumulate external payments arrears will be a performance criterion.

65. Review of program. We will complete with the IMF two reviews of economic developments and policies under the program, the first by February 28, 1993 and the second by May 31, 1993. In addition to assessing whether quantitative performance criteria have been met and evaluating the overall economic situations, both of these reviews will focus on the implementation of incomes policy and of various structural measures.

66. The structural measures that will be assessed during the first review will be: (1) the steps taken to strengthen public expenditure control, tax administration (especially for the value-added tax), and budgetary planning; (2) the effectiveness of monetary control procedures using the new policy instruments introduced under the program; (3) the progress made in implementing the plan for the financial restructuring of the banking system; and (4) the progress made in strengthening mechanisms for the collection, compilation, and timely dissemination of statistics, including the strengthening of staffing and training. The quantitative performance criteria for June 30, 1993 will be specified at the time of the first review.

67. The structural measures that will be assessed during the second review will be: (1) the development of the foreign exchange market and experience with floating exchange rates; (2) progress in simplifying the various tax systems; (3) progress toward developing a market in Government securities; and (4) progress toward completing the privatization process.

September 15, 1992

Net Credit to General Government

	(In litas equivalents of millions of rubles) 1/
Estimate for June 30, 1992	-4,700
Indicative limit for September 30, 1992	-4,700
Limits on:	
December 31, 1992	-4,700
March 31, 1993	-4,000

The financial transactions of the General Government with the banking system are those of the national budget (comprising the central government's state budget and local government budgets) and all government transactions through all extrabudgetary Funds. The extrabudgetary Funds include but are not limited to the Social Insurance Fund, the privatization funds, the Foreign Currency Fund, and the Reserve Fund.

Net credit of the banking system to the General Government is defined as all claims of the banking system on the General Government less all deposits of the General Government with the banking system. In this definition, the deposits of the General Government with the banking system include but are not limited to: the revenue accounts at the Bank of Lithuania and the other banks of the central and local governments; and all extrabudgetary funds, except as noted below. Excluded from deposits of the General Government in this definition are the Privatization Funds, the Agricultural Reform Fund, and deposits of counterpart funds of loans to the General Government for balance of payments support (including but not

1/ The amounts shown below are expressed in rubles. The credit ceilings will be adjusted depending on the exchange rate used to convert rubles into litas at the time the litas is introduced. These ceilings will be adjusted after the Government assumes the responsibility for the liabilities of the Savings Bank.

limited to World bank loans, and loans from the EC/G-24) as well as counterpart funds of grants not fully under control of the Government, which are blocked in the Bank of Lithuania.

The claims of the banking system on the General Government include but are not limited to the expenditure accounts at the Bank of Lithuania and the other banks of the central and local governments, and securities or bills issued by the central and local governments that are held by the Central Bank of Lithuania and the other banks.

For the purposes of the monetary program, the General Government's deposits that are denominated in convertible currency will be converted into rubles at the exchange rate of rubles 135.9 = US$1. The ruble amount will be converted into litas, whereby the credit limits will be adjusted according to the actual conversion factor and the amount of rubles which is converted into litas. Convertible currencies are defined as those that are widely traded in the international foreign exchange markets.

The quarterly limits will be monitored monthly from the accounts of the Bank of Lithuania and the other banks; the Ministry of Finance and the Central Bank of Lithuania will confirm the data for counterpart deposits to loans and grants, which are not fully under control of the government, for balance of payments support. Data on net credit to government, in the agreed format, will be reported to the IMF within thirty days of the end of each month by the Central Bank of Lithuania.

Net Domestic Assets of the Banking System

	(In litas equivalents of millions of rubles) 1/
Estimate for June 30, 1992	30,900
Indicative limit for September 30, 1992	61,000
Limit through December 31, 1992	80,000
Limit through March 31, 1993	87,500

The net domestic assets of the banking system are defined as the difference between the liabilities of the banking system to the nonbank public (broad money) and the net foreign assets of the banking system, both expressed in local currency. Broad money is defined as currency in circulation, including talonas, and the deposits held by residents in domestic and foreign currency, excluding those deposits held by the General Government. For the purposes of the monetary program, net foreign assets consist of two components. The first component is the banking system's gross foreign assets in the form of gold, holdings of SDRs, any reserve position in the IMF, and convertible currencies net. Convertible currencies net consist of gross holdings of convertible currencies (including any deposits with nonresidential financial institutions) net of the following foreign liabilities: short-term liabilities of the banking system vis-à-vis nonresidents, use of Fund resources, and the Bank of Lithuania's other medium- and long-term external debt. The second component of net foreign assets consists of the banking system's net ruble balances in Lithuania's correspondent accounts and bilateral correspondent accounts with countries in the ruble area.

Net domestic assets comprise the balance of the following assets and liabilities: net credit to the General Government as defined in Annex I; gross credit to the nongovernment sector; medium- and long-term convertible foreign assets of the banking system not included in net nonconvertible foreign assets; other net nonconvertible foreign assets (consisting of

1/ The amounts shown below are expressed in rubles. The limits will be adjusted depending on the actual conversion factor at the time the litas is introduced and the amount of rubles converted into litas.

holdings of nonconvertible currencies, net claims on nonresident institutions denominated in nonconvertible currencies, and capital subscriptions to foreign financial institutions); the capital and reserve accounts, the foreign exchange revaluation accounts, the interbank float, and other assets and liabilities.

For the purposes of the monetary program, net foreign assets and those components of net domestic credit and broad money that are denominated in foreign currency will be converted into rubles at the exchange rate of rubles 135.9 = US$1. Following the introduction of the litas, they will be converted from rubles into litas, whereby the limits will be adjusted according to the actual conversion rate and the amount of rubles that are converted.

The quarterly limits will be monitored monthly from the accounts of the banking system. Data on net domestic assets of the banking system, in the agreed format, will be reported to the IMF within thirty days of the end of each month by the Central Bank of Lithuania.

Targets for the Minimum Cumulative Change in Total Net International Reserves and Net International Reserves in Convertible Currencies of the Bank of Lithuania

	Minimum	
	Total	Convertible Currencies
	(In millions of U.S. dollars)	
Position on June 30, 1992	25	76
Cumulative change from June 30, 1992		
December 31, 1992	--	-10
March 31, 1993	15	-10

Total net international reserves consist of the net asset position of the Bank of Lithuania on its correspondent accounts with central banks of the former Soviet Union plus net international reserves in convertible currencies. Net international reserves in convertible currencies consist of gross foreign assets minus foreign liabilities, both expressed in U.S. dollars.

For purposes of the program, gross foreign assets in convertible currencies will include all foreign assets of the Central Bank of Lithuania, including monetary gold, holdings of SDRs, any reserve position in the IMF, holdings of foreign exchange in convertible currencies, and any deposits with nonresident financial institutions denominated in convertible currencies. Excluded from gross foreign assets will be the participation in international financial institutions except the IMF, as well as holdings of nonconvertible currencies and claims on nonresident financial institutions denominated in nonconvertible currencies.

For the purposes of the program, foreign liabilities in convertible currencies will be defined as use of IMF credit plus convertible currency liabilities of the Bank of Lithuania with original maturity of up to and including one year. Excluded from reserve liabilities are any liabilities of the Bank of Lithuania arising from balance of payments support of maturity longer than one year, including such loans from the EC/G-24, other international financial institutions, foreign governments, or foreign banks.

For the entire period of the program, the exchange rates of the SDR, and nondollar currencies vis-à-vis the U.S. dollar, will be kept at their June 30, 1992 levels, and all monetary gold will be valued at US$340 per ounce. The Fund staff will be informed of details of any gold sales, purchases, or swap operations during the program period, so that adjustments can be made to exclude changes in the value of gross reserves that arise merely due to a different valuation of gold. For the purpose of the program, ruble balances in the correspondent accounts will be valued at an accounting rate of rub 135.9 per U.S. dollar.

The targets will be cumulative and will be monitored from information provided monthly by the Bank of Lithuania. Data on net international reserves, in the agreed format, will be reported monthly to the IMF within thirty days of the end of each month by the Bank of Lithuania.

Medium- and Long-Term External Debt

Cumulative Net Disbursements of External Debt	Maximum Limits (In millions of U.S. dollars)	
	1-12 year Maturity 1/	1-5 year Maturity 2/
During the period from June 30, 1992 to:		
December 31, 1992	150	50
March 31, 1993	350	125

1/ Maturities of greater than one year through 12 years.
2/ Maturities of greater than one year through 5 years.

External debt limits apply to net disbursements (disbursements less repayments) of medium- and long-term external debt of original maturities of more than 1 year up to and including 12 years that are contracted or guaranteed by the Government, the Bank of Lithuania or other agencies on behalf of the Government, with sub-limits on such debt of maturities of more than 1 year up to and including 5 years. The Government is defined as comprising the state and local authorities, and all extrabudgetary funds. Excluded from the limits are use of IMF resources; but other balance of payments support of maturity longer than one year is covered by these limits, including loans from official creditors and foreign banks. The Government will not accumulate external payments arrears, and will not contract or guarantee external debts with a maturity of less than one year with the exception of normal import-related credits. Disbursements and repayments shall be valued in the currencies of transactions and converted into U.S. dollars each month at the average exchange rate for the month.

Compliance with the limits shall be verified at quarterly intervals for the dates shown above. Information on net disbursements of external debt, in the agreed format, will be reported monthly to the IMF within thirty days of the end of each month by the Ministry of Finance.

September 15, 1992

Incomes Policy Measures

The incomes policy measures stipulated in paragraphs 41 and 42 of the Memorandum of Economic Policies are defined as follows:

1. The guideline for the increase in the average wage rate for each enterprise, organization, and activity, as well as for the increase in the minimum wage, will be based on the new consumer price index, which is available for the period starting in June 1992. An assessment of wage and price developments since the first half of 1991 is also necessary, however, to specify an incomes policy under which the adjustment in wages will be constrained adequately to avoid macroeconomic instability as Lithuania absorbs the shift in the external terms of trade, which began during 1991. Our most reliable measures of these developments are shown in the table.

2. The index of real wages (that is, the index of ruble wages divided by the index of prices) during July 1992 was 9 percentage points below its average level during the first six months of 1991. Nevertheless, a substantial further decline in real wages seems necessary to cushion both the direct effects on production costs, and the direct and indirect effects on the general government budget, of the sharp rise in the costs of energy and other essential imports. The need to prevent average wages from rising as fast as prices has been made even more pressing by the fact that output per worker has fallen as production has declined. For the economy as a whole, a large loss of real income associated with the shift in the external terms of trade is unavoidable. Part of the rationale for large reductions in real wages in the near term is to spread the real income loss widely throughout the economy and thereby to enable more enterprises to survive and fewer workers to become unemployed.

3. To meet this objective, wages will be frozen during September and October. After the consumer price index for October becomes known during November, a guideline will be announced for an increase in wages, retroactive to November 1. Each enterprise, organization, and activity will be asked at that time to keep the increase of its average wage rate not exceeding the amount of inflation targeted under the program for November-December combined, which is 8 percent, plus any amount by which actual inflation during September and October combined exceeds 30 percent.

Price and Wage Developments

	Consumer Prices 1/		Average Wages			Real Wages 2/
	Index	Percent Change	Rubles	Index	Percent Change	Index
January 1991	100	...	321 3/	100 3/	...	90 4/
February	108	8.4	321 3/	100 3/	...	90 4/
March	127	17.1	321 3/	100 3/	...	90 4/
April	161	27.1	456	142	42.1	88
May	177	9.6	522	163	14.5	92
June	188	6.6	590	184	13.0	98
July	199	5.5	666	207	12.9	104
August	207	4.2	682	212	2.4	103
September	214	3.5	740	231	8.5	107
October	227	6.0	1,029	321	39.1	141
November	291	27.8	1,342	418	30.4	144
December	445	53.0	2,185	681	62.8	153
January 1992	696	56.5	2,279	710	4.3	102
February	1,023	47.1	2,798	872	22.8	85
March	1,306	27.6	3,240	1,009	15.8	77
April	1,490	14.1	4,118	1,283	27.1	86
May	1,617	8.5	4,978	1,551	20.9	96
June	1,815	12.3	5,768	1,797	15.9	99
July	2,309	27.2	6,172	1,923	7.0	83

1/ Based during 1991 on the retail price index for goods and services in its linked inter-monthly version, from January through May 1992 on estimates of what the new consumer price index would have shown, and in June and July 1992 on the fully developed consumer price index.

2/ Average ruble wages divided by the level of consumer prices.

3/ Average for the first quarter of 1991.

4/ Average wages divided by the quarterly average price level.

4. Unless the actual inflation experienced during November-December is substantially higher than the inflation target for those months, the guidelines for maximum average wages established during November will not be raised again until March 1, 1993, when they will be adjusted after consultation between the Government and the IMF staff during the program review in February. The percentage adjustment in the wage guidelines for March will compensate for the amount of inflation targeted under the program for January-March combined, which is 8 percent, and will also take into account any difference between actual inflation and target inflation during the period from November through January. The new guidelines for maximum average wages that become effective on March 1 will be calculated by applying the percentage adjustment to the maximum average wage guidelines set in November. If actual inflation for November-December should exceed the inflation target for the corresponding period by more than 10 percentage points, adjustment of the maximum average wage guidelines will be made before March 1993 after consulting closely with the IMF staff.

5. Unless actual inflation experienced during February-April is substantially higher than the inflation target for that period, the average wage guidelines specified during March will continue to apply until the consultations between the Government and the IMF staff during the second program review in May. The wage guidelines will then be adjusted, effective June 1, 1993, to compensate for target inflation during the second quarter, taking into account any difference between actual and target inflation during the first quarter.

6. After the wage freeze is lifted in November, enterprises, organizations, and activities will be asked to keep the increase in their average wages within the wage guidelines but will be free to raise the wages of different workers by different percentage amounts.

7. The guidelines for average wages will be applied in all budgetary organizations. The minimum wage rate will also be frozen during September and October. Subsequently, the minimum wage will continue to be increased by the same percentage amounts, and on the same dates, as the guidelines for average wages.

September 26, 1992

Dear Mr. Camdessus:

In recent days, Lithuania has been prompted by a strong inflow of rubles to take urgent action to stabilize its economy by withdrawing from the ruble area. While such a step was anticipated in our letter to you of September 21, and the attached Memorandum of Economic Policy in support of our request for a stand-by arrangement with the Fund, the need to act quickly has led us to implement our currency reform in two stages.

Rather than proceed directly to the litas, we have decided as a first step, and with effect from October 1, 1992, to make the coupons (talonas), now circulating with the ruble, the sole legal tender in Lithuania. Pursuant to our decision, which was announced to the public on September 23, 1992, rubles may be exchanged at par for talonas through September 30. After that date, talonas notes will be used exclusively and bank accounts, contracts, and other domestic obligations expressed in rubles will be redenominated at par in talonas. The rate of the talonas against foreign currencies, including the ruble, will be determined by the market. Ruble bank accounts may be maintained after September 30, and the exchange rate of the ruble will be determined based on buying and selling by commercial banks, in the same way as for other foreign currencies.

The step we have taken is a transitional one prior to the introduction of the litas. We will remain in close consultation with Fund staff concerning the timing of the exchange of talonas into litas. The litas will be introduced using a common conversion factor against the talonas. We intend to meet all of the commitments of the Memorandum of Economic Policy which we have transmitted to you in support of our request for a stand-by arrangement with the Fund, and we ask that our request continue to be considered in a timely way.

Specifically, by the completion of our withdrawal from the ruble area as of October 1, we intend to:

(1) Comply with the principle that ruble bank notes withdrawn from circulation should be held by the Bank of Lithuania pending the results of negotiations with the Russian authorities;

(2) Unify exchange rates, which will require the elimination or replacement of various taxes related to foreign exchange transactions or paid in foreign currencies, and abolish the surrender requirements still applied to some specialized state enterprises;

(3) Introduce bank-by-bank credit limits and establish refinancing facilities at the Bank of Lithuania;

(4) Introduce prudential standards for limiting the foreign currency exposure of banks;

(5) Continue to implement for the talonas, and for the litas when it is introduced, full current account and limited capital account convertibility as specified in the Memorandum of Economic Policies.

In addition, before our request for a stand-by arrangement with the Fund is considered by the Fund's Executive Board, we intend to:

(6) Comply with the incomes policy measures, including the establishment of legal authority to impose direct contols on wages paid by state enterprises.

We would also like to inform you that we have already abolished the Government's extrabudgetary foreign currency funds and legislated the repeal of the Government's authority to determine interest rate policy.

We will also comply with the quantitative performance criteria under the Fund arrangement. To reflect the introduction of the talonas as exclusive legal tender the references in the Annexes to our Memorandum of Economic Policies to rubles should be read as talonas, converted from rubles at par or, in future, in litas as converted from talonas.

We wish to re-emphasize our continued full commitment to the program of economic measures contained in the Memorandum of Economic Policies, and our intention to keep the Fund staff fully informed of further developments and economic policies.

Sincerely,

/s/

Aleksandras Abisala
Prime Minister

/s/

Kazimieras Ratkevicius
Acting Governor
Bank of Lithuania

Michel Camdessus
Managing Director
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