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Supplement 1

CONFIDENTIAL

October 20, 1992

To: Members of the Executive Board

From: The Secretary

Subject: Republic of Lithuania - Request for Stand-By Arrangement

The attached supplement to the paper on Lithuania's request for a stand-by arrangement (EBS/92/157, 9/10/92) has been prepared on the basis of additional information. The revised text of stand-by arrangement and a revised draft decision appear on pages 5-10.

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.

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INTERNATIONAL MONETARY FUND

LITHUANIA

Request for Stand-By Arrangement
Supplementary Information

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

(In consultation with other departments)

Approved by John Odling-Smee and Jack Boorman

October 19, 1992

I. Background

Lithuania has recently taken several important measures implementing actions to be taken prior to the start of a stand-by arrangement with the Fund. 1/ In particular, the talonas (a coupon which had been circulating alongside the ruble) was made the sole legal tender on October 1. 2/ At the same time there were apparent delays in implementing other prior actions that the Lithuanian authorities had indicated would be completed by October 1. To assess the success of the currency reform and progress in other areas prior to the scheduled Executive Board discussion, a staff mission comprising Messrs. Knöbl (head), Tersman (both EURII), and Cornelius (PDR) visited Vilnius on October 12-14. The mission was assisted by Mr. Hedfors, Resident Representative. Mr. Fridriksson, Executive Director, participated as an observer. Concurrently, Mr. Moustapha (TRE) visited Vilnius to provide further technical assistance on quota payments following his visit in August.

II. Recent Developments

By early October, the authorities had implemented several prior actions of its program including the introduction of the talonas and the withdrawal of ruble banknotes pending negotiations with the Russian authorities, while continuing to maintain a high degree of currency convertibility. Commercial banking operations had been removed from the Bank of Lithuania. The Bank had become solely responsible for interest rate policy when the Government's authority in this field was abolished.

1/ These are described in the authorities' Memorandum of Economic Policies and letters of September 21 and 26 to the Managing Director, and the staff's report (EBS/92/157, 9/30/92).

2/ The singular is talonas and the plural is talonai.

The introduction of the talonas, a decision taken at short notice in response to a strong inflow of rubles, especially from Ukraine, is viewed by the authorities as an intermediate step pending the introduction of the litas. So far, the move to the talonas seems to have gone smoothly. This step was to have been accompanied (by October 1) by abolition of the Government's foreign exchange funds, and of the surrender requirement applied to some specialized state enterprises. Legislation, however, provided for these steps only after introduction of the litas. In its discussions with the authorities, the mission indicated that prompt action to implement all the remaining prior actions would be necessary.

In response, the authorities indicated that, while further legislative action to abolish the foreign exchange funds and surrender requirement could not be taken at short notice, they could be effectively abolished by decree. A decree to do this was issued on October 14; it also replaces taxes paid in hard currency by taxes payable in domestic currency so that there is no discrimination between domestic and foreign sales. Moreover, the special exchange rate for sales of property and equity shares to Lithuanian expatriates was abolished. These measures were also prior actions under the program.

The Lithuanian authorities have also introduced important measures in fulfillment of prior actions in the area of monetary policy. First, the Central Bank of Lithuania established refinancing facilities under which credit to the commercial banks will be auctioned off. The auction procedures will follow the guidelines suggested by technical assistance missions from the Fund's Monetary and Exchange Affairs Department. Second, regulations were introduced that provide for prudential standards for limiting foreign currency exposure of banks. Third, the Central Bank established bank by bank credit limits. These measures also constituted prior actions but, regrettably, were taken somewhat later than the authorities had earlier indicated. The mission reviewed with the authorities the documentation of these measures, as well as the statutory authority to impose direct controls on wages paid by state enterprises, which the Government has secured to enforce its incomes policy, and found them to be satisfactory.

In addition, the mission assessed recent monetary developments and the implications of the currency reform. While monetary data on the banking system for end-September were not yet available, the balance sheet of the Central Bank suggests that the net foreign assets of the monetary authorities have been significantly higher than projected under the program. To a large extent, this was due to a much larger than envisaged improvement in the correspondent accounts, which, in fact, turned from a deficit of almost rub 7 billion at end-June into a surplus of about rub 2 billion at end-September. This shift occurred before October 1, and the Central Bank is no longer intervening in this market by purchasing noncash rubles. While convertible currency reserves were also higher than expected, this was largely due to a delay in imports, particularly with regard to energy imports from Russia, for which Lithuania has now to pay in convertible currencies in advance. However, at the same time, net domestic assets of the Central Bank were substantially lower than earlier projected, falling from about rub 10.5 billion at end-June to about rub 6.3 billion at end-September, compared with a projected increase in this period of almost rub 9 billion, mainly reflecting a stronger than expected budgetary performance. As a result, reserve money expanded significantly less than foreseen under the program.

As regards the currency reform, a substantially smaller amount of rubles was exchanged for talonai than initially projected. As envisaged under the program, the mission adjusted the performance criteria on net domestic assets of the banking system for end-December 1992 and end-March 1993. While the estimate of rubles in circulation before the currency reform was rub 6.7 billion, in the event only rub 2.2 billion were exchanged for talonai, and the performance ceilings on net domestic assets were accordingly revised downward by talonai 4.5 billion, to talonai 75,500 million at the end of December 1992, and talonai 83,000 million at the end of March 1993. 1/ An equivalent adjustment was made for the indicative limits on the net domestic assets of the Central Bank of Lithuania. Since the recent increase in convertible net foreign assets primarily reflects delays in imports, no adjustments were made concerning performance criteria on net international reserves. In fact, in early October the Government prepaid US$12 million for gas imports from Russia.

Following the currency reform, the talonas appreciated by about 30 percent against the ruble, which, in turn, depreciated sharply against all convertible currencies. The mission confirmed that the Central Bank does not intervene in the foreign exchange market. However, the mission expressed concern about the existence of broken cross rates quoted by some commercial banks, which were due to the fact that not all exchange rates were adjusted on a daily basis. The monetary authorities agreed to advise the commercial banks to change the fixing procedure in future by using daily quotations so as to rule out profitable arbitrage opportunities for market participants.

Despite continued negotiations with the Russian authorities, there remain some problems in the trade and payments system between the two countries. Russia's position is to require payment in advance in hard

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1/ Accordingly, paragraph 6 of the Stand-By Arrangement (Attachment I to EBS/92/157) should read:

"(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 and Table 1 to the Stand-By Arrangement attached hereto, has not been observed; or"

See attached revised text of the Stand-By Arrangement (Attachment I) and Proposed Decision (Attachment II).

currencies for its deliveries, 1/ and to subject oil deliveries to Lithuania to export taxes which raise prices above world market levels. Lithuania has been resisting, and, pending an agreement, Russia has withheld deliveries of oil and gas. While Russia has lately agreed to resume oil deliveries again, this is at a rate which is well below Lithuania's needs. Due to limited port facilities, Lithuania is unable to receive large quantities of oil from other sources.

As regards other developments, revised data suggest that both prices and wages increased less than anticipated in August, i.e., by 14 percent and 7 percent, respectively. There was thus a decline in real wages in August, and preliminary indications are that this decline continued at an accelerated pace in September. Based on these early indications, the decline in real wages since June may well have exceeded the 30 percent anticipated in the program.

III. Staff Appraisal

In recent weeks, the Lithuanian authorities have implemented a number of further measures in fulfillment of the prior actions of their program, as contained in their Memorandum of Economic Policies and letters of September 21 and 26 to the Managing Director. The authorities have expressed their regret over the delay in implementing some of these measures, and the staff is now satisfied that all the prior actions of the program have been met. Moreover, the authorities have reaffirmed their commitment to the actions contained in the program.

The staff has assessed monetary developments in light of the recent currency reform. The introduction of the talonas seems to have gone smoothly. However, fewer rubles were exchanged than previously expected. Consistent with the design of the original monetary program, the staff has adjusted the performance criteria for end-December and end-March with respect to net domestic assets for the banking system, as well as the indicative limits on net domestic assets of the Central Bank. The staff mission confirmed that monetary developments remained well within the limits in the program.

In conclusion, the staff is of the view that the Lithuanian authorities are moving to vigorously implement a strong and comprehensive policy program. The staff would therefore wish to reaffirm its recommendation that Lithuania's request for a stand-by arrangement be approved.

1/ According to the authorities, Russia's position is also that goods shipped to Lithuania should not be re-exported without compensatory payments. Lithuania has accepted this position with respect to trade for which payments are channeled through the correspondent account but is not ready to apply it to other transactions as well.

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 and Table 1 to the Stand-By Arrangement attached hereto, 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.

Table 1. Lithuania: Net Domestic Assets of the Banking System

(In litas equivalents of millions of rubles) 1/

	Previous limits 2/	Revised limits
Estimate for June 30, 1992	30,900	30,900
Indicative limits for September 30, 1992	61,000	61,000
Limit through December 31, 1992	80,000	75,500
Limit through March 31, 1993	87,500	83,000

Source: Information provided by the Lithuanian authorities.

1/ In rubles for June 30, and September 30. From October 1, Talonai have been the sole legal tender in Lithuania. The litas is to be introduced later.

2/ From Lithuania: Request for Stand-By Arrangement (EBS/92/157, 9/30/92), Annex II.

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, Supplement 1.