April 2008
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Republic of Lithuania: 2008 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Lithuania

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2008 Article IV consultation with the Republic of Lithuania, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on February 20, 2008, with the officials of the Republic of Lithuania on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 1, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff statement of April 16, 2008, updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its April 16, 2008 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for the Republic of Lithuania.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF LITHUANIA

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation with the Republic of Lithuania

Approved by Ajai Chopra and G. Russell Kincaid

April 1, 2008

Executive Summary

Background: External and internal imbalances rose in recent years after nearly a decade of impressive economic performance. In 2007, the current account deficit increased to an estimated 13 percent of GDP and end-year CPI inflation accelerated to 8¼ percent. Competitiveness remains broadly appropriate, though there has been some erosion due to rapid wage growth. Over the past half year, a tightening of lending standards has led to a welcome cooling of the housing market.

Outlook: Although the economy's momentum is strong, the tightening of financing conditions is likely to lead to an orderly reduction of imbalances in 2008–09 (a soft landing). With credit growth expected to slow substantially, property-related domestic spending should ease. While a soft landing is the most likely scenario, sharper-than-expected cooling of the housing market or scaling back of external financing could lead to more rapid adjustment (a hard landing). Conversely, it is possible—though less likely—that imbalances could persist (no landing). Against this background, the key policy objectives are to support a soft landing and be prepared for a hard landing.

Fiscal policy: Although government debt is low, fiscal policy provided stimulus in 2007, which was counter-productive given already-strong demand pressures. The fiscal contraction envisaged for 2008 is helpful, but additional tightening is warranted. For 2009, the government's fiscal target is appropriate, but further measures will be needed to achieve it. The new fiscal responsibility law should help to promote fiscal discipline over the medium term, but the legal framework could be improved further.

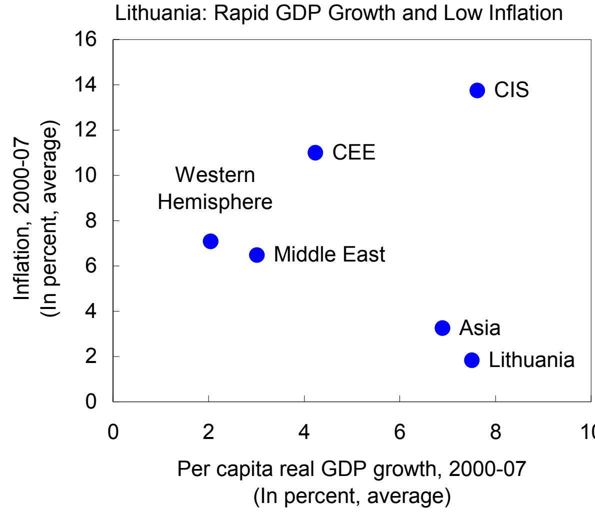
Financial system: Indicators of the banking system's soundness are generally satisfactory and are expected to remain so under the soft landing scenario. The regulatory and supervisory framework for banks is in line with international standards, and the Bank of Lithuania conducts effective supervision of all banks operating in Lithuania. Given the potential impact of low-probability extreme events on the banking system, banks' capital buffers should be increased and banks' contingency plans in the event of liquidity shocks should be further discussed. Supervision of the non-bank sector needs to be improved.

Contents Page

I. Introduction

1. **Economic performance over much of the past decade has been impressive, reflecting in part broad macroeconomic stability**. The growth rate of real GDP per capita has been one of the highest among emerging market countries, inflation one of the lowest, and the unemployment rate has declined. These favorable developments have been supported by EU accession, rapid financial integration, and generally sound macroeconomic policies, including the currency board arrangement, the low and declining level of public debt, and relatively flexible labor and product markets.

Lithuania: Rapid GDP Growth and Low Inflation



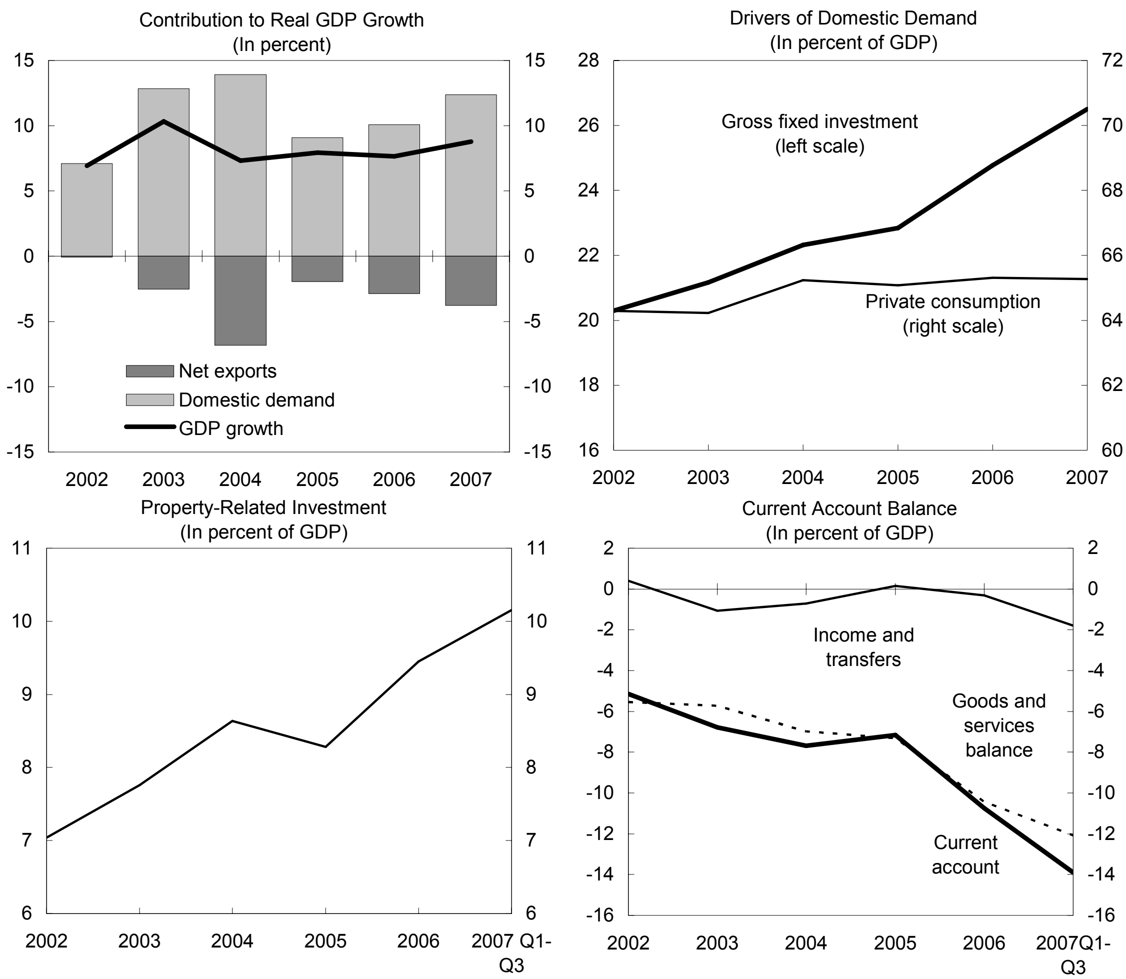
Source: IMF, World Economic Outlook.

2. **However, external and internal imbalances increased in 2007**. The external current account deficit widened to an estimated 13 percent of GDP and end-year CPI inflation rose to 8¼ percent. House prices continued to increase, accompanied by a rising share of property-related investment in GDP and rapid credit growth. Rapid wage growth led to an appreciation of the real effective exchange rate.

3. **With parliamentary elections scheduled for October 2008, political pressures to adopt populist measures are rising**. For example, against the advice of the government and despite a veto by the president, parliament recently passed a law that will reduce the VAT rate on fruit and vegetables in January 2009.

II. Rising Imbalances in 2007

4. **Economic growth increased in 2007, reflecting strong investment and fiscal stimulus** (Tables 1 and 2). GDP growth rose from 7¾ percent in 2006 to 8¾ percent in 2007, driven by domestic demand. Investment was boosted by the booming property market and a temporary surge in purchases of transportation equipment related to the rapid growth of cross-border trucking services. Private consumption was supported by a tight labor market and increased government transfers, notably restitution payments related to savings and land. Given the high import content of domestic demand, the current account deficit (CAD) widened to 13 percent of GDP. Production disruptions at the oil refinery contributed to the rise in the current account deficit (by about 1 percentage point of GDP). In recent years, the widening current account deficit has reflected the rise in foreign-financed investment, and has been accompanied by rapid productivity growth (Box 1).



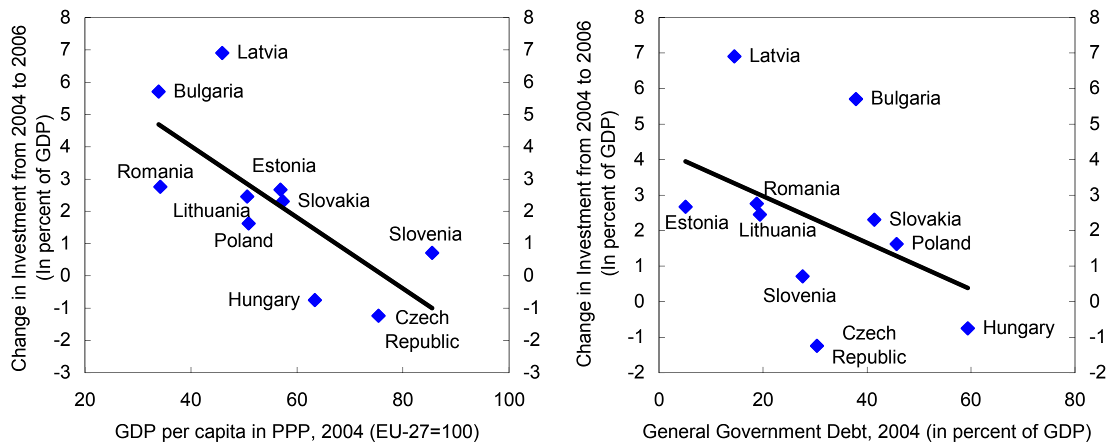
Sources: Statistics Lithuania; Bank of Lithuania; and IMF staff estimates.

5. **Credit growth—especially to the property sector—remained rapid in 2007, but has recently shown tentative signs of slowing** (Figure 1). Increases in bank loans to corporates and households continued to exceed nominal GDP growth, leading to rising debt ratios. Most household debt is at variable interest rates and about half is denominated in foreign currency (largely in euro), though household debt is reportedly concentrated among higher-income households, and increasing loan maturities have moderated the rise in debt service burdens. About half of bank loans are property-related. As credit has grown more rapidly than deposits, banks have funded their lending by borrowing from abroad. Reflecting concerns about rapid credit growth, the Bank of Lithuania (BOL) and the parent banks of major Lithuanian banks encouraged a tightening of lending practices, including more conservative valuation of collateral. As a result, year-on-year credit growth eased from 51 percent at end-2006 to 45 percent at end-2007, and the month-on-month rate fell sharply in January 2008. At the same time, regional concerns and the global financial turbulence

Box 1. Current Account and Productivity Developments

The widening of the CAD in recent years is due to the rise in foreign-financed investment. The increase in the ratio of gross fixed investment to GDP reflects EU accession, the relatively low level of income per capita, and low public debt. Another structural factor has been the sharp rise in EU funds, which have not only financed public sector investment but also stimulated complementary private sector investment.

The Investment Boom was Largely Driven by Fundamentals



Sources: Eurostat; and IMF staff estimates.

The widening CAD has been accompanied by rapid productivity growth in the tradables sector. Between 2000–06, productivity in tradables rose by almost 60 percent, reflecting in part declining employment in agriculture as workers emigrated or moved to other sectors, including construction. The productivity growth differential between tradables and nontradables (about 30 percent) was much larger than the average in Lithuania's trading partners. Other things equal, rapid productivity growth in tradables (relative to nontradables, relative to trading partners) causes an appreciation of the equilibrium real exchange rate.

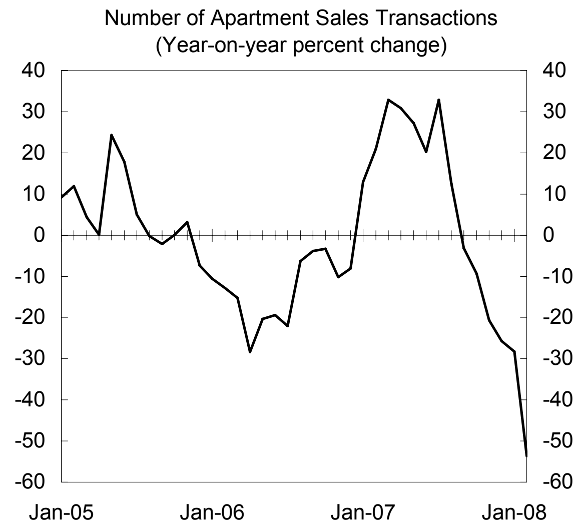
Sources of Productivity Growth, 2000-06
(In percentage points)

	Lithuania	Trading partners
Tradables productivity growth	57.6	20.7
Output	46.9	13.5
Employment	-10.7	-7.2
Nontradables productivity growth	26.4	9.1
Output	38.8	18.2
Employment	12.4	9.0
Tradables minus nontradables	31.1	11.6

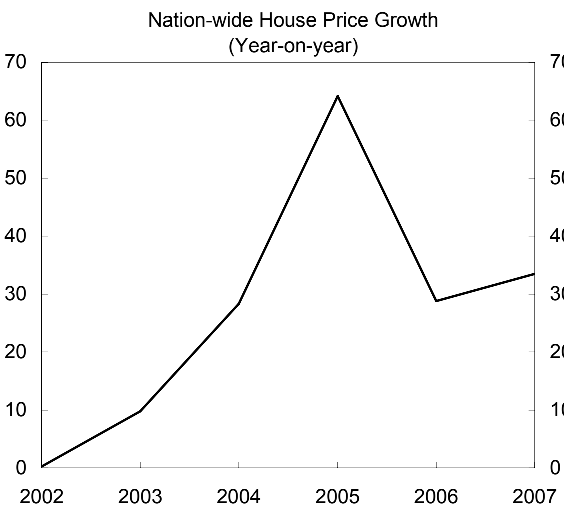
Sources: Eurostat; Haver; and IMF staff calculations.

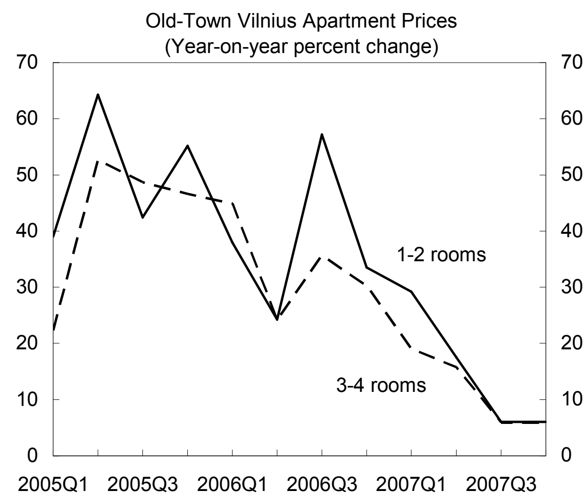
prompted increases in foreign currency bond spreads and domestic currency lending rates, leading to a rise in the share of loans in foreign currency (Figure 2).

6. **Nation-wide house prices increased sharply in the first half of 2007, but the property market started to cool in the second half of the year**. The share of property-related investment in GDP has risen by 2¼ percentage points since 2002–04. Growing demand for dwellings reflects in part the increase in headship rates as income per capita rises. The supply of dwellings has reportedly been limited by land restitution issues, urban planning restrictions, and weaknesses in infrastructure. Following the tightening of lending standards, the housing market is now cooling, with house prices in Vilnius no longer rising and the volume of house sales declining.



Source: Central registry.



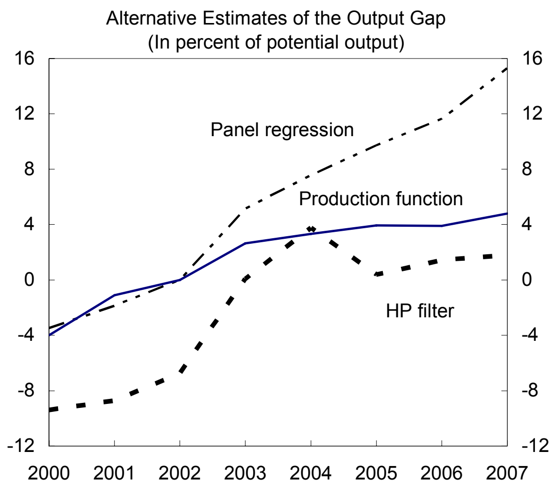


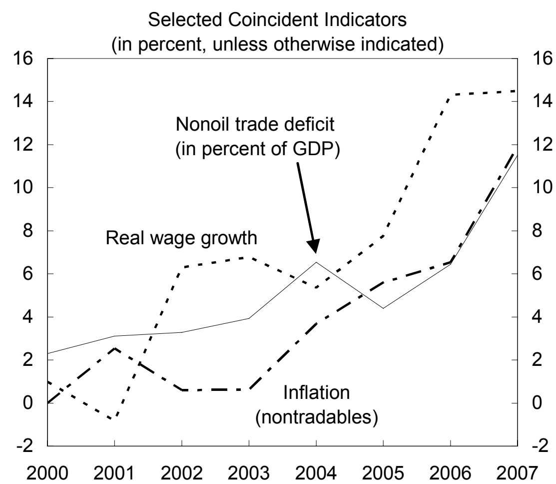
Sources: Central registry; InReal; and IMF staff estimates.

7. **Demand pressures increased for much of 2007, but started to ease towards the end of the year** (Figure 3). The unemployment rate fell to 4¼ percent, job vacancies increased, and real wage growth remained high. Capacity utilization rose year-on-year through October, but has since begun to decline. Staff's production function suggests potential growth in 2007 of about 8 percent and an output gap of 4½ percent of GDP, though estimates of the output gap are surrounded by large margins of uncertainty, especially in an economy that is undergoing rapid structural change (Box 2). With output gap estimates not significantly different from staff's, the authorities agreed that demand pressures are substantial. CPI inflation rose to 10¾ percent in February 2008, mostly reflecting higher food and energy prices, but also higher core inflation, which is due to increasing nontradables inflation (especially in the hospitality and property-related sectors). Inflation is well above the Maastricht criterion.

Box 2. Estimates of the Output Gap[1]

Different methods produce a wide range of measures of the level of the output gap in 2007, with the production function approach suggesting the most plausible estimate. The Hodrick-Prescott (HP) filter indicates a positive output gap in 2007 of about 2 percent of GDP, but suffers from an end-point problem, which—if output is indeed above potential—tends to underestimate the level of the gap. A cross-country panel regression approach to measuring potential growth yields an output gap of about 15 percent of GDP, but underestimates potential growth (and thus likely overestimates the output gap) in the Baltic countries in the sample period. The production function approach suggests an intermediate estimate of about 4½ percent of GDP.





Sources: Lithuanian authorities; and IMF staff estimates.

All three estimates broadly match direct measures of resource pressures between 2000-07. Nontradables price inflation, real wage growth, and the non-oil trade balance all point to a tightening of supply constraints. Correlation coefficients between these coincident indicators and estimates of the output gap vary somewhat, but the differences are not statistically significant. The short sample period cannot be extended backwards because there is a break in the wage data in 2000. As discussed above, methodological considerations suggest that the production function (PF) approach yields the most plausible estimate.

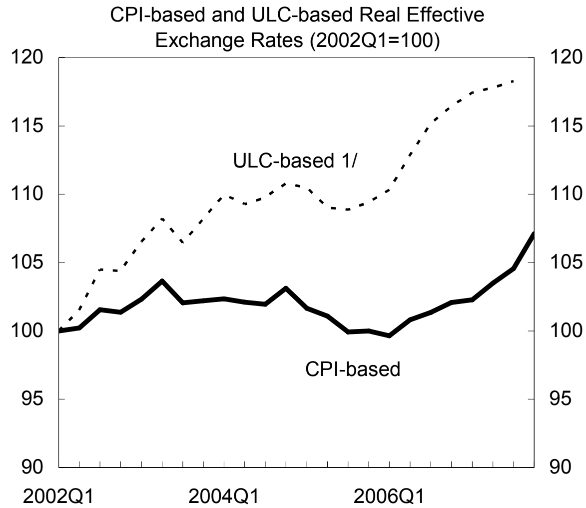
Correlation Coefficients between
Estimates of the Output Gap and Coincident Indicators, 2000–07

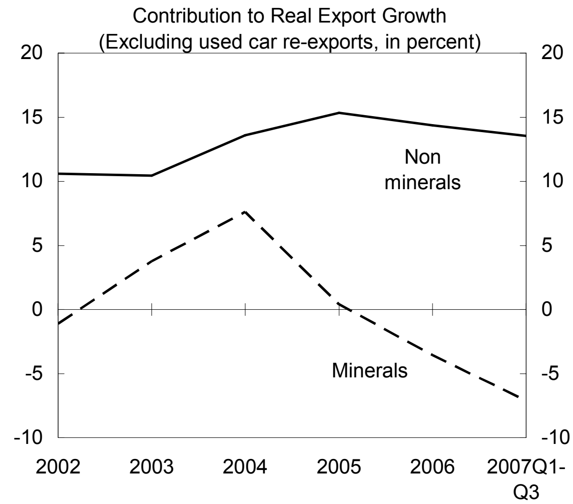
	HP Filter	Panel	PF
Inflation (nontradables)	0.50	0.78	0.74
Confidence interval 1/	0.10 to 0.83	0.55 to 0.96	0.34 to 0.92
Real wage growth	0.73	0.86	0.84
Confidence interval 1/	0.36 to 0.91	0.64 to 0.96	0.59 to 0.95
Non-oil trade deficit	0.72	0.85	0.74
Confidence interval 1/	0.36 to 0.91	0.64 to 0.96	0.36 to 0.91

Source: IMF staff calculations.
1/ 80 percent confidence intervals.

[1] See the selected issues paper on methodologies to estimate the output gap.

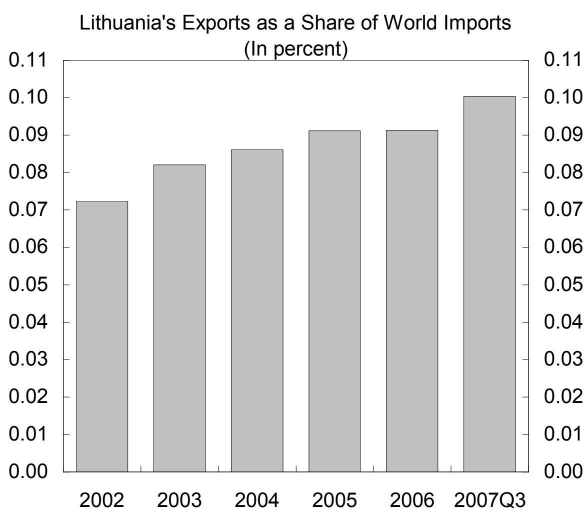
8. **The real effective exchange rate (REER) continued to appreciate in 2007, though export growth remains strong**. Reflecting the pickup in inflation and wage growth, the CPI- and ULC-based REERs appreciated by 3½ percent and 4½ percent,

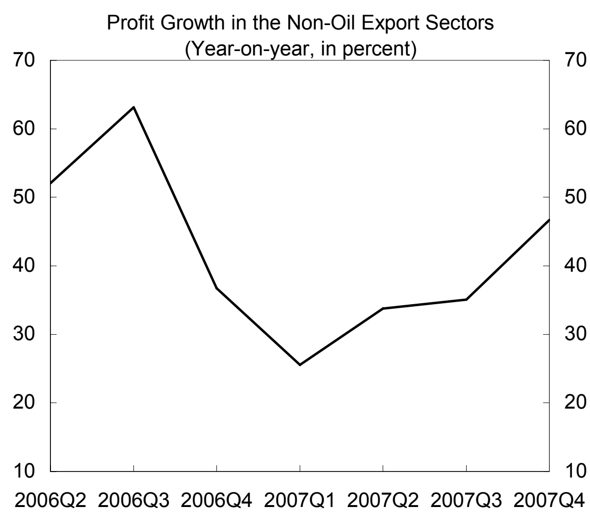




Sources: Eurostat; Statistics Lithuania; IMF, Information Notice System; and IMF staff estimates.
1/ Includes Russia.

respectively, in 2007. While oil exports have declined (due to production disruptions at the oil refinery), non-oil real export growth remains rapid. Lithuania's exports have continued to gain market share and export firms remain highly profitable.





Sources: IMF, Direction of Trade Statistics; Bank of Lithuania; and IMF staff estimates.

9. **The authorities and staff agreed that the REER is broadly in line with fundamentals, but large uncertainties surround this assessment**.[1] The underlying CAD is somewhat wider than the equilibrium CAD, though within the margins of uncertainty:

[1] See the selected issues paper on methodologies to assess the current account.

- Staff estimate that the underlying CAD in 2007 (adjusted for the business cycle, past movements in the real effective exchange rate, and other temporary factors) is 8½ percent of GDP. The Bank of Lithuania has a similar estimate.

Deriving the Underlying Current Account Balance
(In percent of GDP)

	Adjustment
2007 Current account balance	-13.0
Temporary effects (oil refinery)	1.0
Lithuanian business cycle	4.7
Export partners' business cycle	-0.4
Real exchange rate movements	-1.0
Underlying current account balance	-8.6

Methodology: Isard and Faruqee (1998), OP167.

- The standard CGER macro-balance approach suggests an equilibrium CAD of 2½ percent of GDP. However, this estimate may underestimate the equilibrium CAD in a setting of EU convergence and rapid financial integration. Based on Abiad and others (WP/07/64), which attempts to incorporate these effects, the equilibrium CAD is estimated to be about 4¾ percent of GDP (the standard error of the estimate is ¾–3¼ percent of GDP). The gap between the underlying CAD and the equilibrium CAD is 3¾ percent of GDP, which implies a real exchange rate overvaluation of 11 percent. Taking into account medium-term EU capital transfers of 1½ percent of GDP, which are a stable and predictable source of financing, the gap is 2¼ percent of GDP, implying a real exchange rate overvaluation of 7 percent.

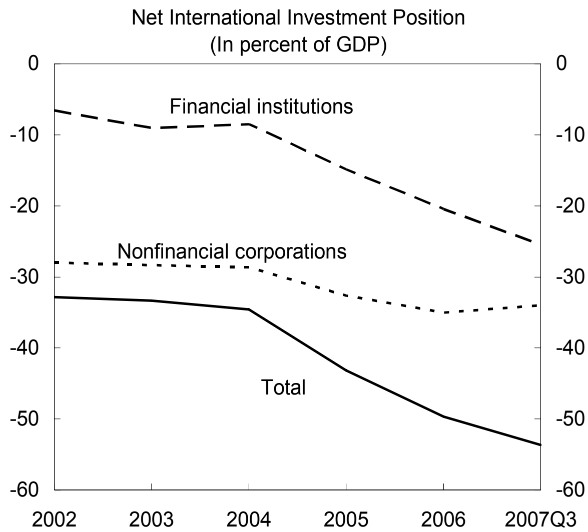
- The standard CGER external sustainability approach indicates that the CAD that stabilizes the net external asset position is 4 percent of GDP. Taking into account medium-term EU capital transfers of 1½ percent of GDP, the gap is 3 percent of GDP, implying a real exchange rate overvaluation of 9 percent.

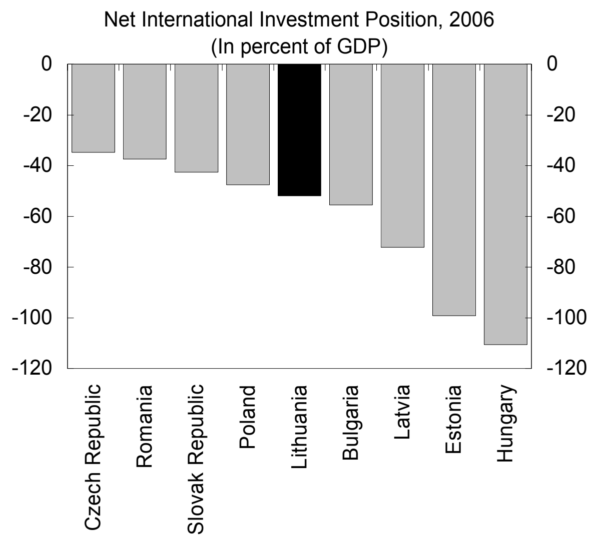
By contrast, the standard CGER equilibrium real exchange rate approach suggests that the actual REER is about 10 percent more depreciated than the equilibrium REER. The forecast error is 10–15 percent. The average of the three estimates of real exchange rate misalignment (equilibrium real exchange rate, macro-balance, and external sustainability) is close to zero.

Estimates of Real Exchange Rate Misalignment
(In percent)

Equilibrium Real Exchange Rate Approach	-9.6
Macrobalance Approach	6.9
External Sustainability Approach	9.0
Overall Assessment	About 0

10. **Reflecting the sizable current account deficit, Lithuania's net external liabilities have increased, representing a risk to external stability** (Tables 3 and 4). Net external





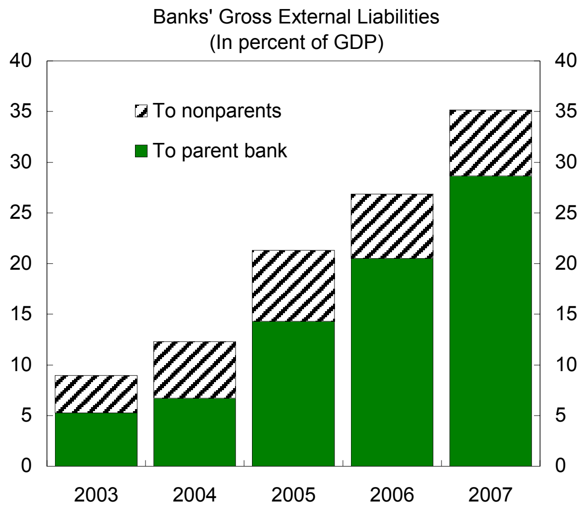
Sources: Bank of Lithuania; IMF, International Financial Statics; and IMF staff calculations.

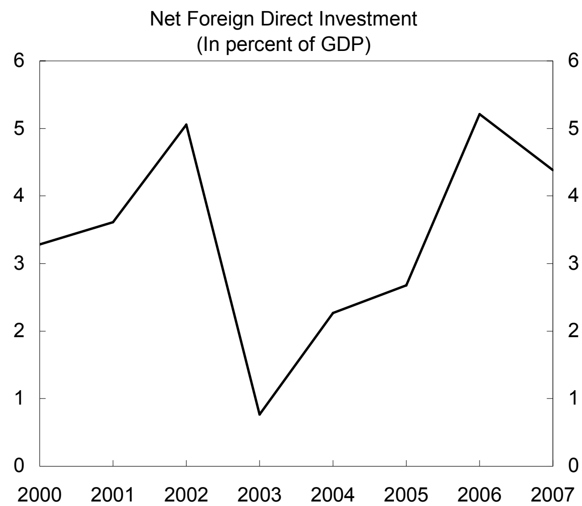
liabilities rose from 50 percent of GDP at end-2006 to 54 percent of GDP in 2007Q3, though short-term liabilities remain well below short-term assets. Lithuania's net external liabilities, and especially gross short-term liabilities, are smaller than in Latvia or Estonia. In Lithuania, financial institutions' net external liabilities have increased sharply in recent years, reflecting bank borrowing to finance credit growth. Most of this external borrowing is from parent banks and the share of liabilities to parents is rising. However, the absolute level of liabilities to non-parents (representing borrowing by banks that do not have parent banks) has risen, increasing refinancing risks. Corporate net external liabilities are mostly due to inward FDI, which has been directed mainly at the industrial sector, with property-related sectors accounting for less than one-tenth of inward FDI.

Distribution of FDI Inflows, 2005-07
(In percent of total)

	Share
Manufacturing	38.4
Financial intermediation	14.3
Wholesale and retail trade	12.0
Post and telecommunications	10.9
Electricity, gas and water supply	10.5
Construction and Real Estate	8.9
Others	5.0

Source: Statistics Lithuania.



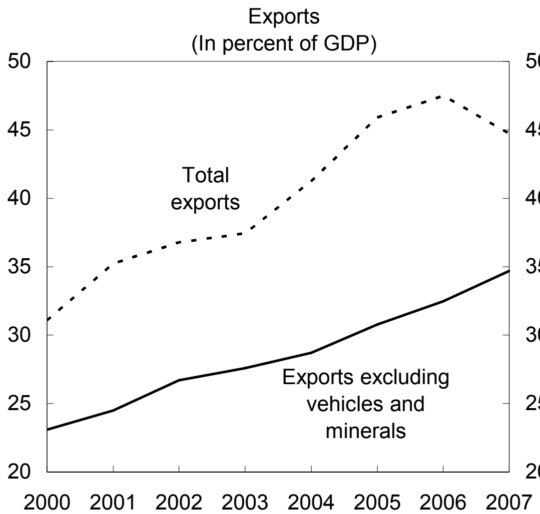


Sources: Bank of Lithuania; and IMF staff calculations.

11. **In Estonia and Latvia, where economic imbalances were larger, the economic cycle turned earlier than in Lithuania** (Figure 4). Reflecting parent banks' decisions to rein in lending, credit flows declined, accompanied by slowing domestic demand growth and narrowing current account deficits.

III. Soft Landing Likely in 2008–09

12. **Although the economy's momentum is strong, there was agreement that the tightening of financing conditions is likely to lead to a gradual easing of domestic demand growth (soft landing)**. With credit growth expected to slow substantially from 45 percent at end-2007 to 20 percent at end-2008, property-related investment (as a share of GDP) will likely fall, though strong profitability in export-oriented sectors and the reduction in the corporate income tax rate will support overall private investment, and EU funds will continue to support strong public investment (Tables 5–6). Similarly, purchases of consumer durables will likely ease, though the low unemployment rate and the cut in the personal income tax rate will underpin continued robust after-tax wage growth and thus consumption of non-durables. Moreover, slowing GDP growth in all main export markets—and especially in Estonia and Latvia—will dampen external demand growth.



Sources: Statistics Lithuania; and IMF staff calculations.

Direction of Exports, 2004-07
(In percent of total)

	Share
Advanced economies	52.0
Advanced EU countries	42.8
Other advanced countries	9.2
Emerging economies	48.0
CIS	19.9
Estonia and Latvia	15.7
Other emerging EU countries	7.4
Other emerging countries	5.0

13. **Staff's central forecast, broadly shared by the authorities, is that the slowing of credit growth will lead to an orderly reduction of imbalances in 2008–09** (Table 7). The easing of credit growth and banks' foreign borrowing should be accompanied by lower growth rates of domestic demand and imports, and a narrower current account deficit. Staff projects real GDP growth of 6½ percent in 2008 and 5½ percent in 2009, in line with the March Consensus forecast. CPI inflation would decline to 7 percent by end-2008 and 4½ percent by end-2009, mostly reflecting the fading impact of sharp increases in food and energy prices. The current account deficit would narrow to 10½ percent in 2008 and 8¾ percent in 2009. Under this scenario, net external liabilities would rise to about 66 percent of GDP by 2013 and external debt to about 68 percent of GDP (Appendix III).

Lithuania: Key Macroeconomic Variables, 2005-09

	2005	2006	2007	2008	2009
	(Year-on-year percent change, unless otherwise specified)				
Real GDP	7.9	7.7	8.8	6.5	5.5
Consumption	10.1	10.5	9.7	7.2	5.2
Investment	2.0	3.9	14.7	4.0	3.3
Exports of goods and services	17.7	12.2	5.2	13.0	9.1
Imports of goods and services	17.2	13.8	9.1	11.2	7.2
Prices and Labor Market					
CPI inflation (end of period)	3.0	4.5	8.2	7.0	4.5
Nominal wage growth	10.0	16.7	18.8	17.5	13.0
Unemployment rate (in percent)	8.3	5.6	4.4	4.4	5.0
	(In percent of GDP)				
Fiscal sector					
General government balance 1/	-1.3	-1.5	-1.9	-1.2	-0.4
External sector					
Current account deficit	-7.1	-10.8	-13.0	-10.5	-8.8
Gross external debt	49.3	64.1	65.8	64.2	64.1

Sources: Bank of Lithuania; Statistics Lithuania; and IMF staff estimates.
1/ Includes restitution payments in expenditures.

14. **While a soft landing is likely, large uncertainties surround the outlook and there is a risk of a hard landing**. The experience of other countries shows that rapid house price increases are sometimes followed by abrupt house price declines. In addition, Lithuania's dependence on external financing makes it vulnerable to a sharper scaling back of new lending by parent banks. If these risks materialize, the fall in GDP growth would be sharper and the adjustment of the current account deficit quicker (hard landing). In this case, bank credit quality would likely deteriorate, putting stress on the banking system and possibly leading to a further retrenchment of lending. Conversely, it is possible—though less likely—that property market sentiment could recover or that competition for market share among banks could interfere with the expected moderation in credit growth. In this situation, GDP growth would not slow and imbalances would remain large (no landing).

15. **Against this background, the key policy objective is to promote macroeconomic stability by supporting a soft landing and being prepared for a hard landing** (Box 3). The discussions focused on three questions:

- What fiscal policy stance is needed to help reduce demand pressures and build fiscal cushions?
- How should financial supervision help ensure a measured pace of credit growth and strong bank asset quality?
- How is the economy positioned to ease supply bottlenecks and facilitate the reallocation of resources?

Box 3. Implementation of Fund Policy Advice

Fiscal policy: Fiscal policy was expansionary in 2007, in contrast to the tightening recommended by the Fund. In line with Fund advice, there was no mid-year budget. The balanced-budget fiscal rule introduced in November 2007 is consistent with the Fund's advice on fiscal restraint, though reform of the expenditure framework, as well as measures to enhance transparency and increase independent scrutiny, are still under consideration.

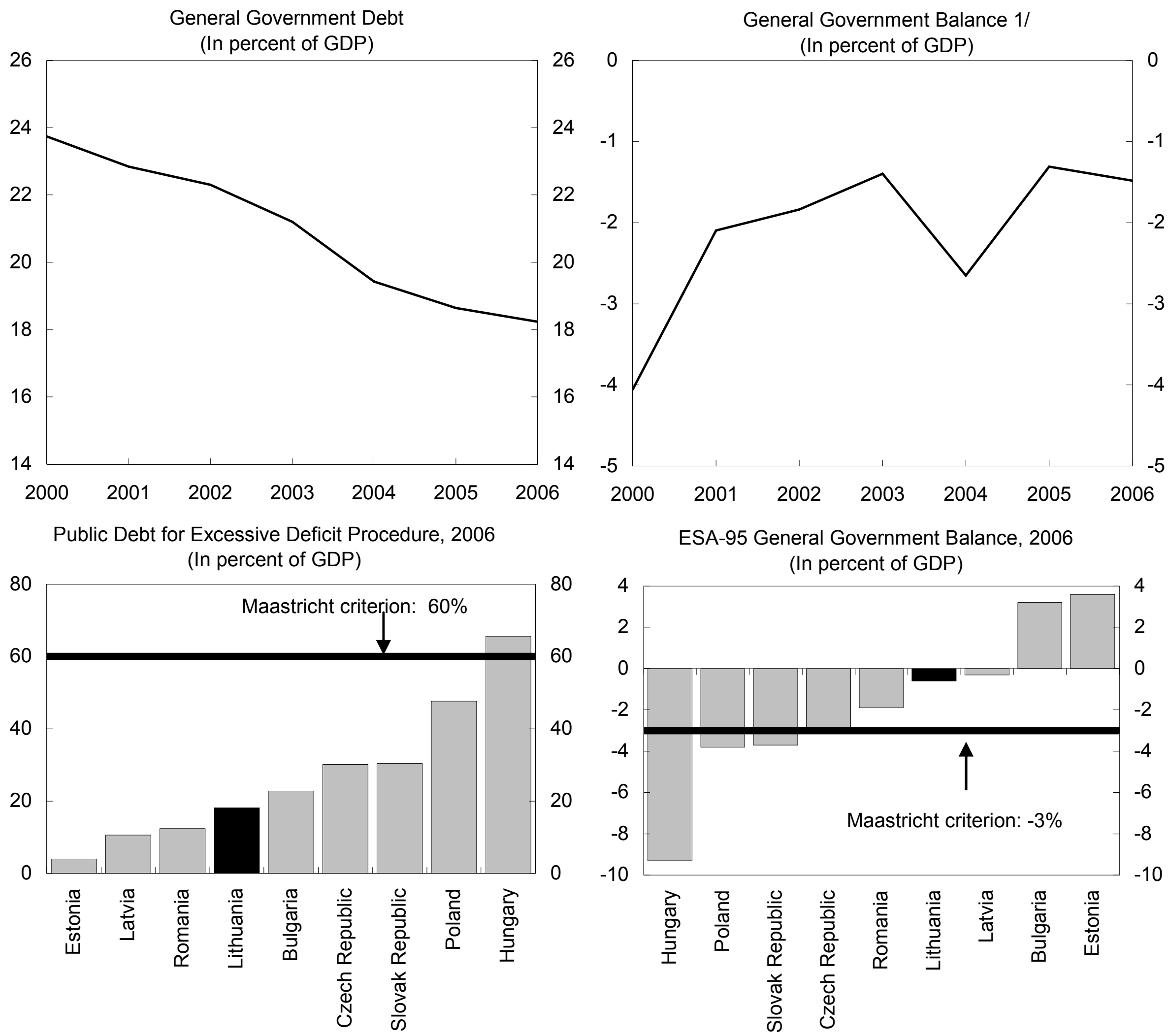
Financial stability: Consistent with the Fund's advice, the BOL has taken measures to strengthen banks' capital bases, encouraged better risk management, increased disclosure requirements, broadened the collection of information in the credit registry, and made public statements on risks related to the housing market.

Economic flexibility: While the labor market is already relatively flexible, no progress has been made in easing restrictions on working hours. The completion of some municipal land use plans has facilitated residential and commercial property development.

IV. Fiscal Tightening Needed

16. **Public finances are generally sound, but fiscal policy was procyclical in 2007** (Table 8). Between 2000–06, general government debt fell from 24 percent of GDP to

18 percent of GDP, reflecting small fiscal deficits and rapid GDP growth. However, in 2007, the fiscal deficit (including restitution payments) widened to 2 percent of GDP. This gave rise to a fiscal stimulus of ½ percent of GDP, which—given the economy's cyclical position—was counter-productive.



Sources: Lithuanian Ministry of Finance; and IMF staff estimates.
1/ ESA-95 plus restitution payments.

17. **In staff's view, the fiscal contraction envisaged for 2008 is helpful but more is needed**. The cyclically-adjusted fiscal deficit (including restitution payments) is projected to narrow by 1 percent of GDP, which will help to relieve demand pressures. However, with the spending of EU funds expected increase, the overall withdrawal of demand is only ½ percent of GDP. Given the need to support the soft landing and increase fiscal cushions, staff argued for additional fiscal consolidation of ½ percent of GDP. Greater fiscal contraction would not only have a direct impact on aggregate demand, but also provide a credible signal of the government's commitment to macroeconomic stability, helping to boost investor confidence and to focus expectations on the need for slower growth. In addition, staff argued that it would be prudent to take advantage of the current favorable economic situation to increase fiscal cushions, given the potential for large revenue losses in the event of a hard landing. Staff suggested that additional fiscal contraction could be

achieved by postponing restitution payments and accelerating planned increases in excise taxes.

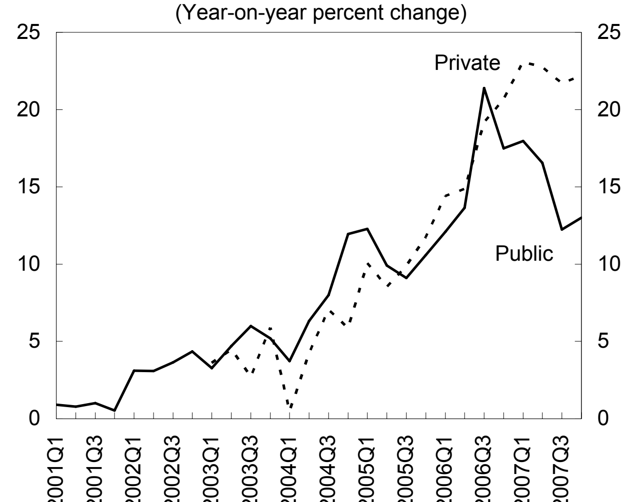
Lithuania: General Government Operations, 2006-10
(In percent of GDP)

	2006	2007	2008	2009	2010
Revenue	33.8	34.5	34.8	34.7	34.9
Expenditure 1/	35.2	36.4	36.0	35.1	35.1
Of which: Restitution payments	0.9	1.4	0.4	0.2	0.2
Net lending (+)/borrowing (−)	-1.5	-1.9	-1.2	-0.4	-0.2
Cyclically adjusted net lending (+)/borrowing (−)	-2.6	-3.2	-2.3	-1.2	-0.7
Demand impulse from fiscal operations	0.2	0.6	-0.9	-1.1	-0.6
Net EU funds	2.2	2.4	2.7	2.4	2.7
Demand impulse from EU funds	0.8	0.1	0.3	-0.3	0.3
Memorandum item:					
Demand impulse from EU funds and fiscal operations	0.9	0.8	-0.6	-1.4	-0.3
General government debt	18.2	17.3	15.6	14.6	13.8

Source: IMF staff estimates, based on the authorities' policy plans.
1/ Includes restitution payments.

18. **While recognizing the desirability of fiscal contraction from a macroeconomic perspective, the authorities pointed to pressing social needs**. The authorities noted that, as a share of GDP, current spending is expected to fall in 2008, with only social benefits projected to rise. Staff observed that some social benefits (such as two years of paid maternity leave) appear to be generous by international comparison. Regarding the government wage bill, the authorities noted that it has been growing in line with nominal GDP and is expected to continue to do so. They added that, as private sector wages have recently been growing more rapidly than public sector wages, the government is having trouble recruiting and retaining appropriately-skilled staff. Turning to staff's specific recommendations, the authorities said that they would consider staff's suggestion to accelerate the planned increase in excise taxes, but that the law requires restitution payments to be completed by 2009.

Nominal Wage Growth
(Year-on-year percent change)



Source: Statistics Lithuania.

19. **The authorities plan further fiscal contraction in 2009**. After taking restitution payments into account, the latest Convergence Program envisages fiscal balance, which would imply fiscal adjustment of 1½ percent of GDP. Staff welcomed the magnitude of the

planned fiscal consolidation, but observed that—on staff's somewhat less optimistic assumptions about revenue buoyancy—the fiscal deficit is likely to be closer to ½ percent of GDP, implying adjustment of about 1 percent of GDP. In addition, staff noted that—on the government's projections—fiscal consolidation in 2009 is being achieved primarily by cutting the nationally-financed public investment program, which is undesirable given the urgency of improving public infrastructure.

20. **Staff argued that additional measures will be needed to achieve the desired fiscal contraction in 2009**. Given that demand pressures are expected to remain significant on staff's central forecast, staff recommended that fiscal policy aim for cyclically-adjusted balance by 2010. For 2009, this would imply fiscal adjustment of 1¼ percent of GDP and a fiscal deficit (including restitution payments) of ¼ percent of GDP. This could be achieved by limiting the growth of current spending to nominal GDP growth and removing exemptions on VAT, PIT, and social security taxes. Staff added that, if GDP growth does not ease as projected, then greater fiscal contraction would be desirable. Conversely, if the economic slowdown is considerably sharper than projected, then fiscal policy should not exacerbate the downturn. In the unlikely event that the output gap turns negative, discretionary counter-cyclical stimulus would be appropriate. The authorities said that they would consider staff's suggestions.

21. **The authorities underlined the role of the new fiscal responsibility law in promoting fiscal discipline over the medium term**. The law, which was enacted in November 2007, prohibits mid-year budgets, requires that revenue overperformance be saved, and stipulates that the government budget aim for balance or better, subject to escape clauses intended to avoid procyclical policy in an economic downturn. The authorities are planning to enhance transparency by showing exactly how a proposed budget conforms to the fiscal target in the law, and to reduce the risk of procyclicality in an economic upturn by providing an explicit assessment of whether a budget is inflationary. The authorities said that they would consider staff's suggestion to strengthen independent scrutiny of the economy's cyclical position and some key revenue assumptions. Separately, the authorities pointed to recent scrutiny of government ministries' expenditure planning by an external accounting firm. The audit recommended better targeted and quantified evaluation criteria, and improved cost-benefit analysis. Staff supported these recommendations and added that better integration of strategic expenditure planning and budgeting would enhance the medium-term spending framework.

V. Higher Bank Capital Buffers Advisable

22. **The Financial Sector Assessment Program (FSAP) Update finds indicators of the banking system's soundness to be generally satisfactory** (Figure 5 and Tables 9–10). Profitability is high and nonperforming loans are low, and capital adequacy has increased in recent years. Looking ahead, the cooling of the housing market and the slowdown in GDP growth will likely increase nonperforming loans and dampen profitability somewhat.

23. **The dominance of foreign-owned banks in the banking system constitutes both a source of strength and a risk**. Foreign-owned banks account for about 85 percent of the sector's assets and the foreign parent banks generally have an S&P credit rating of A+. In

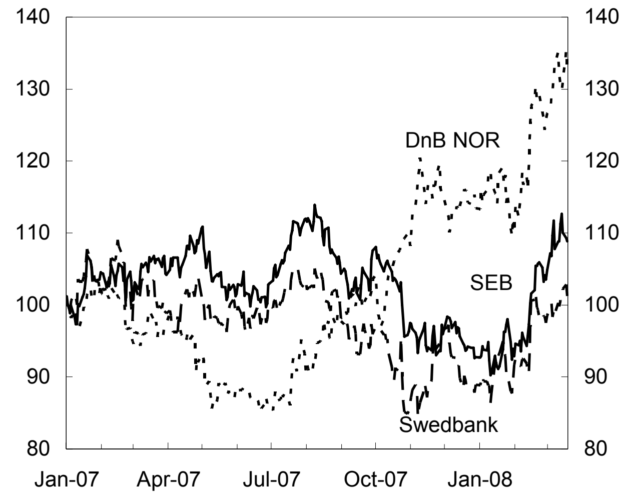
Bank Ownership, end-2007

Bank	Parent bank	S&P Rating of parent 1/	Asset share (%)
SEB Vilniaus Bankas	Skandinaviska Enskilda Banken AB (Sweden)	A+	30.5
Hansabankas	Swedbank AB (Sweden)	A+	23.9
DNB NORD Bankas	DNB NOR Bank ASA (Norway)	A+	13.1
Snoras Bankas	Domestic bank	...	7.1
Nordea Bank Finland	Nordea Bank AB (Sweden)	AA-	7.0
Sampo Bankas	Danske Bank (Denmark)	AA-	6.8
Ukio Bankas	Domestic bank	...	5.0

Sources: Bank of Lithuania and Standard and Poor's.
Note: Four other banks have asset shares of less than 5 percent.
1/ Fitch's rating for the banking system—assuming no parent support for subsidiaries—is D (i.e., the second lowest). Fitch's rating of parent support for the foreign-owned subsidiaries is 1 (i.e., the highest).

the event of a domestic shock, the ownership of Lithuanian banks by reputable foreign banks supports the resilience of the system. Although Swedish banks' exposures to the Baltics have risen, increasing downside risks for these banks, the Swedish central bank's latest *Financial Stability Report* concludes that their resilience to shocks is generally strong. In particular, the report notes that Swedbank and Skandinaviska Enskilda Banken (SEB) continue to have comfortable margins to deal with a pronounced slowdown in the Baltics. At the same time, the dominance of foreign-owned banks provides a channel for contagion, either from the global financial turmoil or a regional shock. For example, downward pressure on parent banks' equity prices due to concerns about Baltic exposures could prompt a reduction in their lending to Lithuania beyond the slowdown already assumed in staff's central scenario.

Equity Prices of Swedish Banks
(Relative to the FTSE Eurofirst 300 Bank Index, January 2, 2007=100)

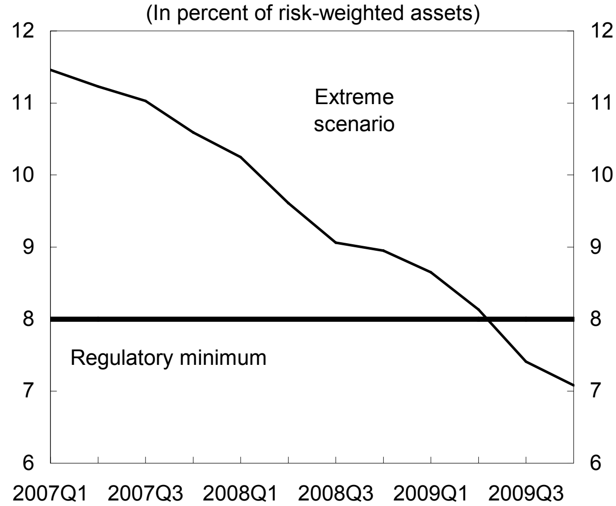


Source: Bloomberg.

24. **The regulatory and supervisory framework for banks is in line with international standards and the BOL has taken actions to strengthen bank soundness**. Laws and regulations on bank supervision conform with EU directives, and the BOL conducts effective supervision of all banks operating in Lithuania. In recent years, the BOL has strengthened banks' capital bases by raising the effective risk weight on residential mortgages, restricting the amount of current-year profits that count toward regulatory capital, and asking banks to fully retain profits. The BOL has also urged banks to pay due attention to loan-to-value ratios and debt-service-to-income-ratios, and to conduct stress tests on borrowers' debt service capabilities under different interest rate scenarios.

25. **However, stress tests indicate that low-probability extreme events would have a significant impact on bank capital**. Stress tests suggest that in an extreme scenario—involving a 50 percent fall in property prices, 500–600 bps increases in domestic lending rates, and a 10 percent decline in GDP below baseline after three years—the average capital adequacy ratio would eventually fall below the 8 percent minimum. Staff recommended that, in the upcoming process of validating banks' internal ratings-based models, the BOL should ensure that banks fully capture the risk characteristics of their loan portfolios in their models; otherwise, these risks should be covered by bank-specific capital surcharges under Pillar 2. The BOL said that it would continue to urge banks to strengthen their capital bases.

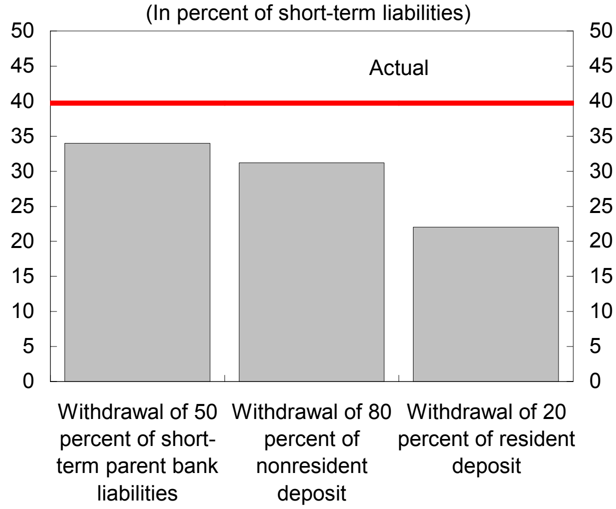
Capital Adequacy Ratios in Credit Risk Stress Test
(In percent of risk-weighted assets)



Sources: Bank of Lithuania; and IMF staff estimates.

26. **Liquidity stress tests suggest that liquidity would be broadly adequate under individual liquidity stress scenarios, but might not be sufficient under a combination of severe events**. The banking system appears resilient to a substantial reduction in short-term parent bank funding, given the prevalence of long-term parent financing and banks' high liquidity ratios, and to a substantial deposit withdrawal. However, liquidity positions might not be sufficient under a combination of these events, though the probability of such a combination of severe events is low.

Liquidity Ratios in Liquidity Risk Stress Tests
(In percent of short-term liabilities)



Source: IMF staff estimates.

27. **While the lender of last resort (LOLR) framework is adequate, LOLR operations are limited by the currency board arrangement**. The BOL has the authority to conduct LOLR operations, though these are limited by the required foreign exchange coverage of BOL liabilities under the currency board. The BOL is working to update the implementation procedures for LOLR operations, including guidelines for the valuation and approval of collateral. The current reserve cover is about 140 percent, compared with the minimum permissible cover of 100 percent. Staff recommended that the Lithuanian authorities further discuss contingency plans (including credit lines) with banks, parent banks, and home country authorities. In addition, staff suggested that the authorities weigh the fiscal cost of increased reserve cover against the potential benefits.

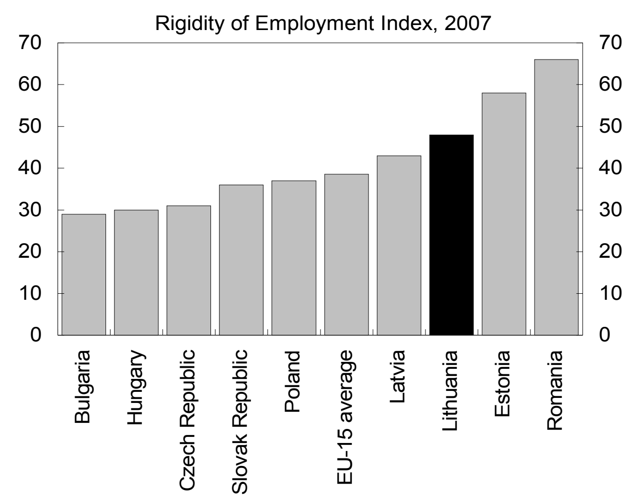
28. **Deposit insurance coverage is extensive, though the funding of the deposit insurance fund is below its target level**. The level of coverage is in line with the relevant EU directive, coverage relative to GDP per capita is higher than the EU average, and virtually all depositors have full coverage of their deposits. Arrangements to ensure the speedy payoff of depositors are in place (and were tested in two bank failures in the late 1990s). Given the rapid growth of bank deposits, which now amount to 40 percent of GDP, the deposit insurance reserve fund has not yet reached its target funding rate of 3–4 percent of insured deposits. At 2¼ percent of insured deposits, the fund at this stage would have sufficient resources to cover a small bank failure. Staff observed that the introduction of risk-based insurance premia would help curtail certain banks' aggressive collection of deposits and help accelerate capital accumulation in the deposit insurance fund.

29. **Cross-border crisis management arrangements are largely in place, but still untested**. The BOL has bilateral Memoranda of Understanding on supervisory cooperation with all foreign financial supervisors of the parent banks of Lithuanian subsidiaries or branches. The BOL also has crisis management agreements with the EU and with regional central banks, and has participated in multilateral crisis simulation exercises. A domestic crisis management plan is currently being discussed by the relevant authorities.

30. **As regards the non-bank financial sector, assets have grown rapidly and financial institutions are becoming increasingly sophisticated**. However, high staff turnover at the Lithuanian Securities Commission (LSC) results in a loss of relevant market experience. To address this, Fund staff suggested that the LSC should be allowed to pay market-based salaries and should be given an adequate and stable source of funding, including fees from market participants. In addition, the governance structure of pensions funds should be strengthened and cross-sectoral supervisory arrangements should be reviewed to address conflicts of interest by pension fund managers (banks and insurance companies).

VI. ECONOMIC FLEXIBILITY IS GOOD

31. **Lithuania ranks relatively well on most measures of doing business, though economic flexibility could be further increased in some areas**. For example, restrictions on working hours reduce labor market flexibility. Obstacles to immigration, including time-consuming procedures for residency and work permits, as well as restrictions on family members, inhibit an easing of labor market pressures. Though improving, land planning processes remain cumbersome. The proliferation of regulatory standards associated with the large number of regulatory bodies and required licenses also creates barriers to redeploying resources.



Source: World Bank Doing Business, 2007.

VII. Staff Appraisal

32. **The recent rise in external and internal imbalances is a concern**. An excess of aggregate demand over the economy's supply potential has led to a wide current account deficit and an increase in domestic inflationary pressures. The underlying current account deficit is somewhat larger than its estimated equilibrium value, though within the margins of uncertainty. The deterioration in the net external asset position represents a risk to external stability. Inflation is well above the level in the euro area and an obstacle to euro adoption. Although the level of the real effective exchange rate is still broadly appropriate, given strong productivity growth in earlier years, continued rapid wage growth could erode competitiveness.

33. **The tightening of financing conditions is likely to lead to an orderly easing of imbalances in 2008–09, but there is a risk of a hard landing**. Following the tightening of lending standards, the housing market is already cooling and credit growth will likely slow substantially. Therefore, while the economy's underlying momentum remains strong, domestic demand growth is expected to slow, leading to a narrowing of the current account deficit and an easing of inflationary pressures. However, the experience of other countries shows that rapid house price increases are sometimes followed by abrupt house price declines. In addition, Lithuania's reliance on external financing makes it vulnerable to a sharper scaling back of new lending by parent banks. If these risks materialize, domestic demand growth could slow quickly (a hard landing). There is also a small risk that domestic demand growth could remain strong and imbalances could continue to rise (no landing).

34. **The stance of fiscal policy in 2008 is helpful, but more fiscal contraction is needed to support a soft landing and increase fiscal cushions**. To help focus expectations on the need for slower growth and to reduce the size of the cyclically-adjusted fiscal deficit, additional fiscal contraction of ½ percent of GDP would be advisable. In any event, the government should resist pressures to cut taxes, introduce new exemptions or tax credits, or raise spending in the run up to the October 2008 elections. On the central scenario of a soft landing, the government should start preparing for additional fiscal consolidation in 2009, with the goal of achieving cyclically-adjusted balance by 2010. If GDP growth does not slow as projected, then greater fiscal consolidation would be desirable. Conversely, if the economic slowdown is considerably sharper than projected, then fiscal policy should not exacerbate the downturn. In the unlikely event of excess supply, discretionary fiscal stimulus should be considered. The new fiscal responsibility law is welcome, but the legal framework could be further improved. In this regard, the government's plans to enhance transparency and reduce the risk of procyclicality in an economic upturn are welcome.

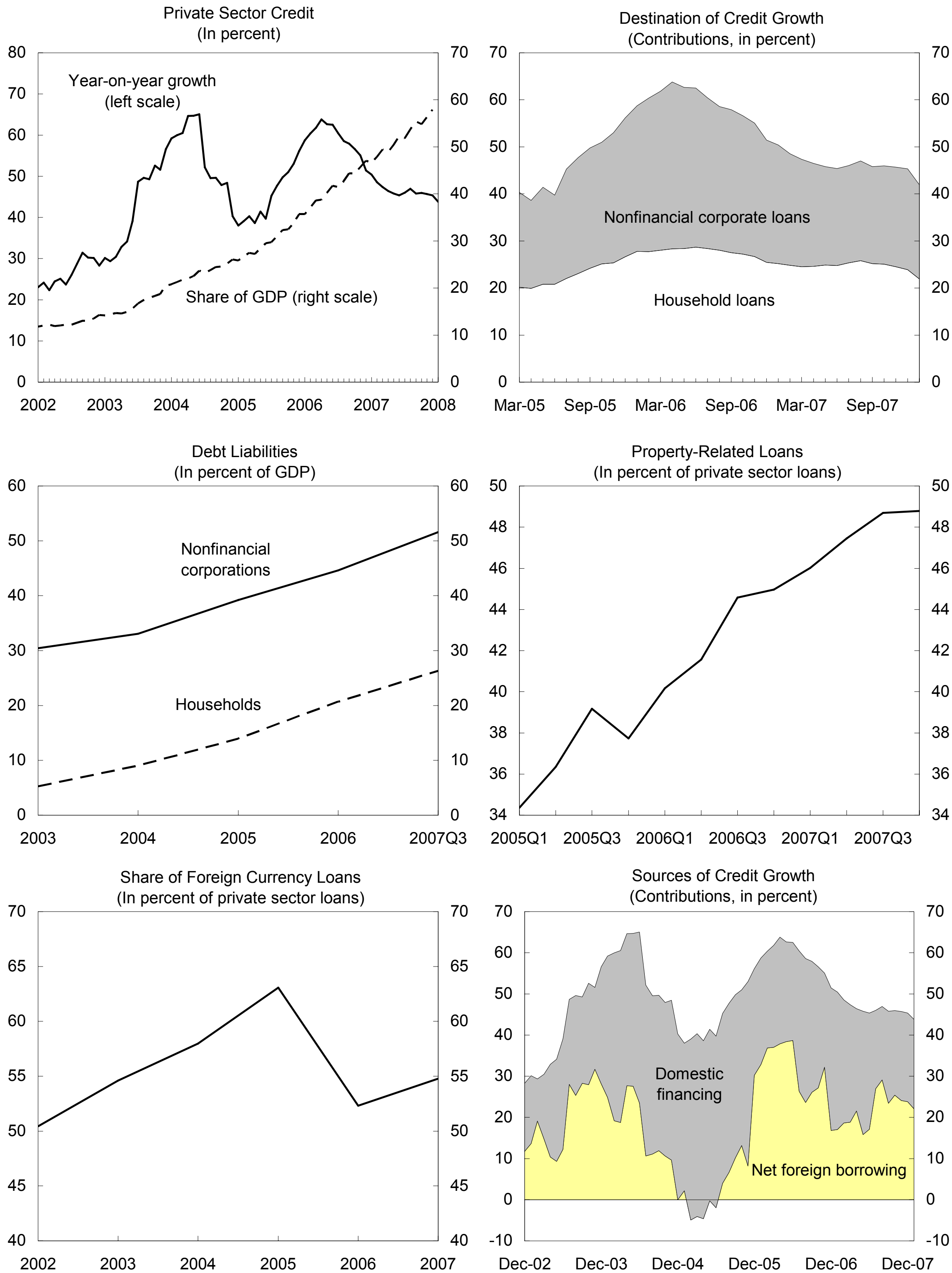
35. **The priorities for bank supervision are to maintain high lending standards and strong risk management, and increase capital buffers**. Indicators of the banking system's soundness are generally satisfactory and are expected to remain so under the soft landing scenario. The regulatory and supervisory framework for banks is in line with international standards, and the BOL conducts effective supervision of all banks operating in Lithuania. In recent years, the BOL has appropriately strengthened banks' capital bases and encouraged strong risk management. Given the potential impact of low-probability extreme events on the banking system, it would be advisable to raise banks' capital buffers and to further discuss with banks, parent banks, and home country authorities contingency plans (including credit lines) in the event of liquidity shocks. As regards the non-bank financial

sector, improved supervision is needed given the rapid growth of assets and the increasing sophistication of financial institutions.

36. **Greater economic flexibility would support a soft landing by easing supply bottlenecks and facilitate the reallocation of resources in the event of a hard landing**. Among the priorities should be easing restrictions on working hours, removing obstacles to immigration, speeding land planning processes, and streamlining the assessment of firms' compliance with regulatory standards.

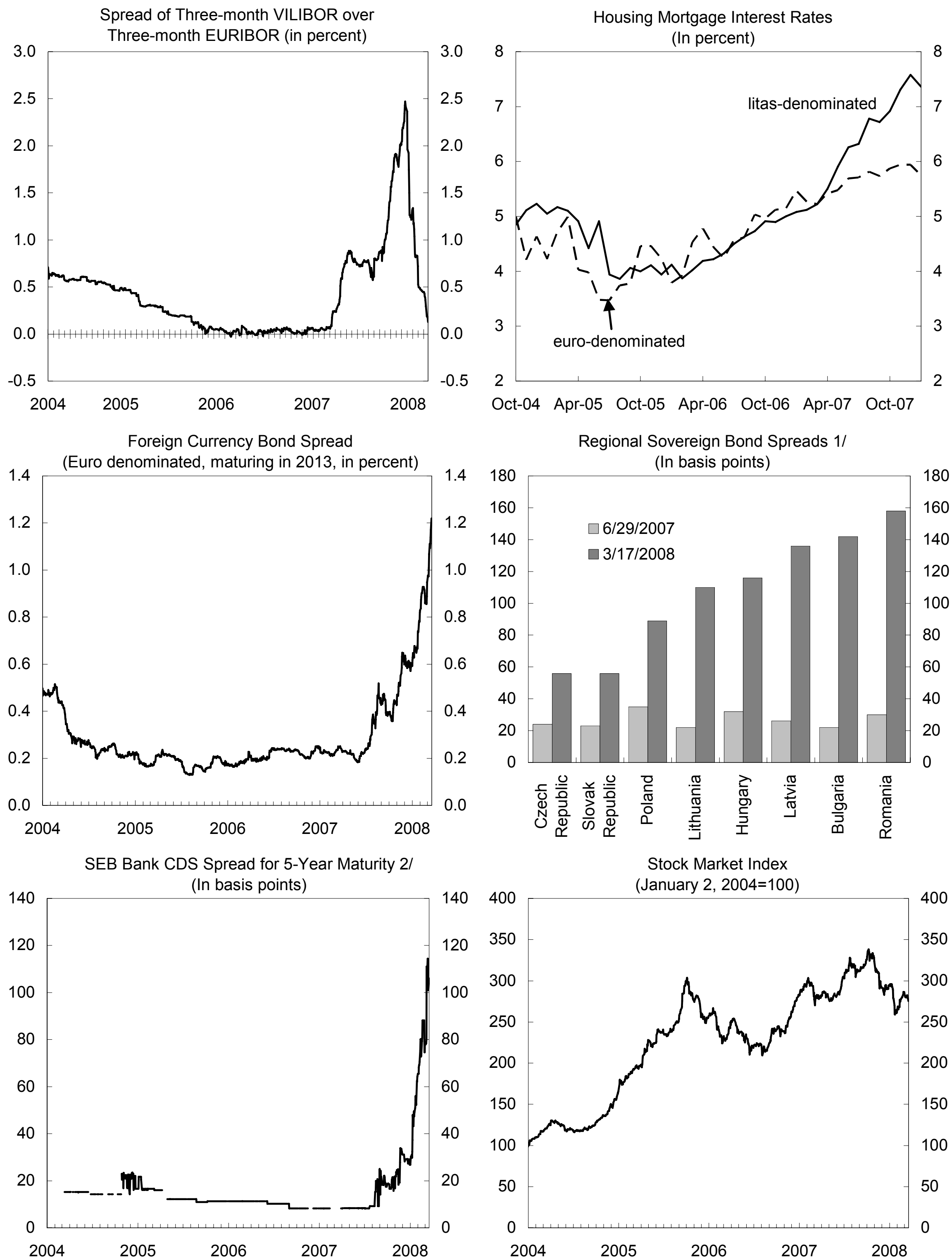
37. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Lithuania: Credit Growth, 2002-08



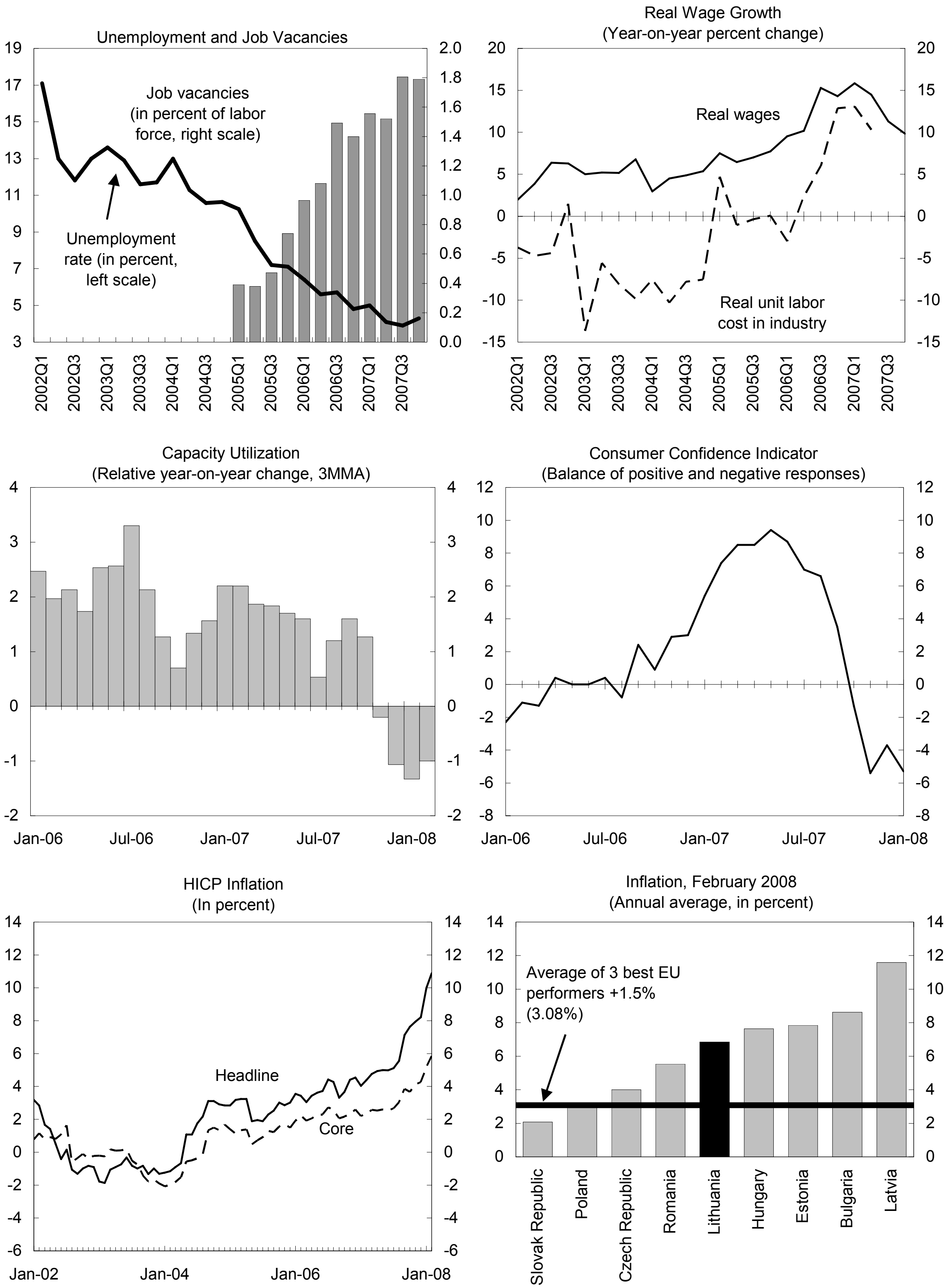
Sources: Bank of Lithuania; and IMF staff estimates.

Figure 2. Lithuania: Financial Indicators, 2004-08



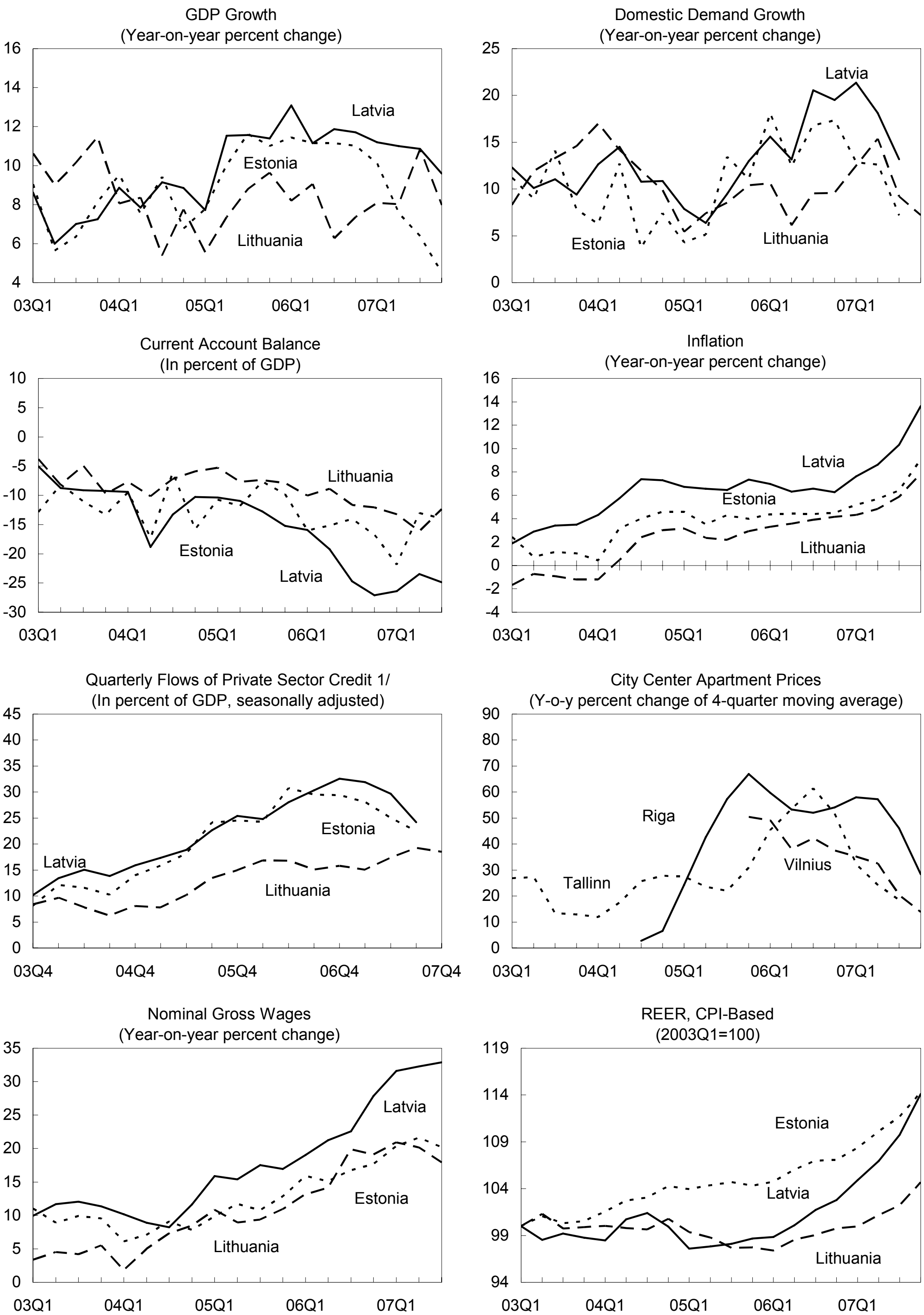
Source: Bloomberg.
1/ JP Morgan Euro EMBI Global sovereign spreads. Data for Latvia are spreads of bond maturing on 4/2/14 versus comparable maturity of German Bunds.
2/ Gaps signify that no transaction took place.

Figure 3. Lithuania: Demand Pressures, 2002-08



Sources: Statistics Lithuania; Bank of Lithuania; Eurostat; and IMF staff estimates.

Figure 4. Baltics: Macroeconomic Developments, 2003-07



Sources: Eurostat; Eesti Pank; Latvijas Banka; Bank of Lithuania; Statistics Estonia; Latvijas Statistika; Statistics Lithuania; Center of Registers; and IMF staff calculations.

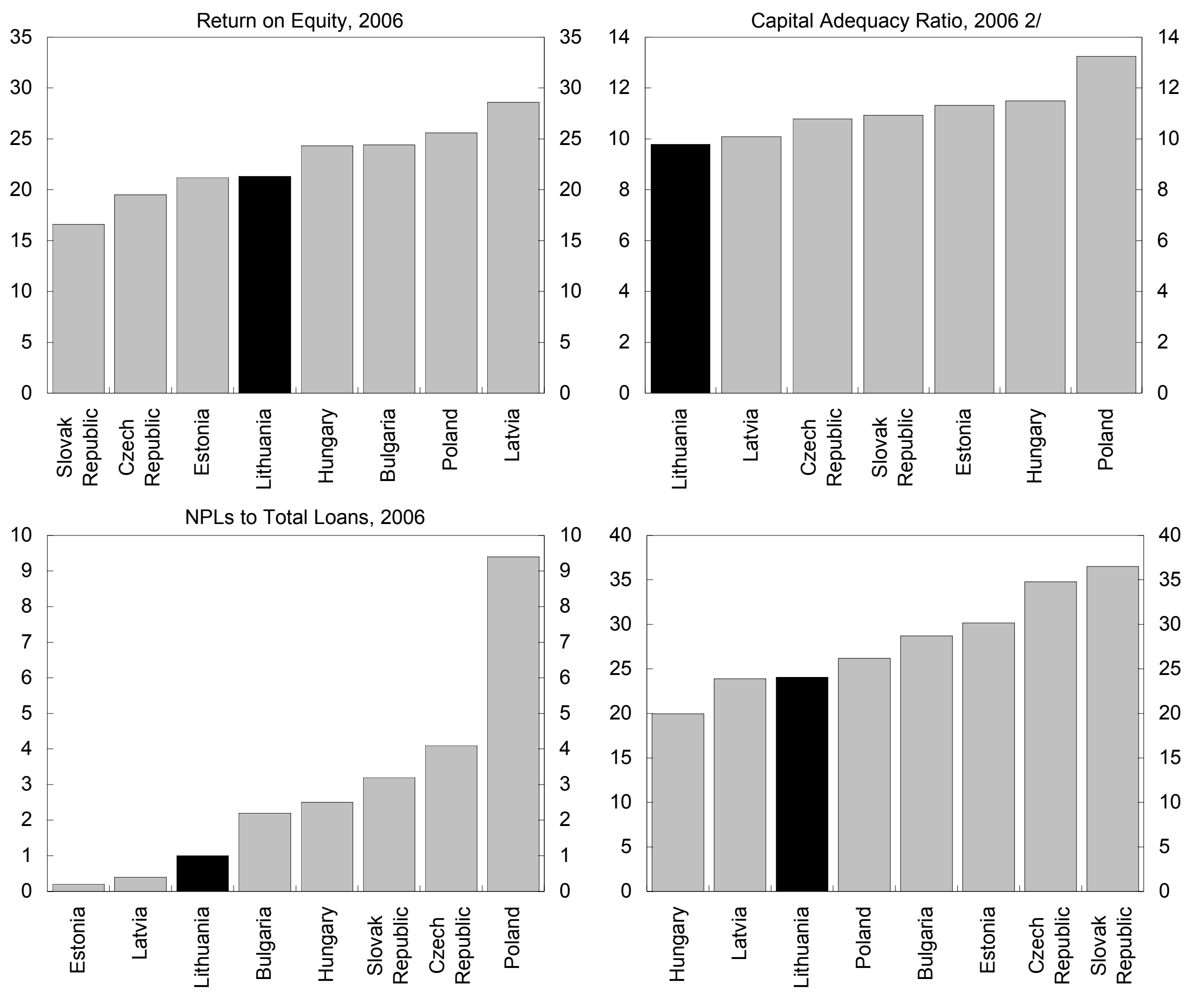
1/ Excluding bank credit to nonbank financial institutions.

Figure 5. Lithuania: Banking System Indicators, 2002-07

Key FSIs for the Banking System
(In percent, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007
Regulatory capital to risk-weighted assets	14.8	13.3	12.4	10.3	10.7	10.9
Nonperforming loans to total gross loans	5.3	2.4	2.2	0.6	1.0	1.0
Nonperforming loans net of provisions to capital	21.1	11.7	12.6	5.7	9.7	10.4
Before-tax return on average assets	0.9	1.2	1.3	1.1	1.5	2.0
Before-tax return on average equity	9.1	11.8	13.5	13.8	21.4	27.2
Liquid assets to current liabilities	42.0	42.4	41.7	42.9	41.9	43.5
Net open FX position/regulatory capital 1/	-1.5	10.8	-1.9	-1.0	-1.4	-2.4

Source: Bank of Lithuania; and staff calculations.
1/ This ratio does not include euro net open positions for 2005 and 2006.



Sources: IMF, Global Financial Stability Report; European Central Bank; and IMF staff estimates.
2/ Lithuania restricts the amount of retained profits in regulatory capital. If adjusted, the capital adequacy ratio would increase to 11.1 percent.

Table 1. Lithuania: Selected Economic and Social Indicators, 2004-09

	2004	2005	2006	2007	2008	2009
				Est.	Projection	
Real economy						
Nominal GDP (in billions of litai)	62.6	71.4	81.9	96.8	113.0	127.3
GDP (in billions of U.S. dollars)	22.5	25.7	29.8	38.3	48.1	54.5
Real GDP growth (year-on-year, in percent)	7.3	7.9	7.7	8.8	6.5	5.5
Average CPI (year-on-year change, in percent)	1.2	2.7	3.8	5.8	8.3	6.1
End-of-period CPI (year-on-year change, in percent)	2.8	3.0	4.5	8.2	7.0	4.5
GDP deflator (year-on-year change, in percent)	2.7	5.7	6.6	8.6	9.6	6.8
Average monthly wage (annual percent change)	5.7	10.0	16.7	18.8	17.5	13.0
Unemployment rate (in percent) 1/	11.4	8.3	5.6	4.4	4.4	5.0
Labor productivity (annual percent change)	7.4	5.2	5.9	7.9	6.7	6.3
Unit labor cost (annual percent change)	-5.2	0.9	10.2	10.0	10.1	6.3
Saving-investment balance (in percent of GDP)						
Gross national saving	16.9	17.8	16.6	16.2	17.3	17.9
General government	0.6	2.1	2.6	2.5	3.2	3.2
Nongovernment	16.3	15.7	14.0	13.7	14.1	14.6
Gross national investment	24.0	25.1	27.0	29.2	27.7	26.6
General government	3.2	3.4	4.1	4.4	4.4	3.6
Nongovernment	20.7	21.7	22.9	24.8	23.3	23.0
Foreign net savings	7.1	7.3	10.4	13.0	10.5	8.8
Nongovernment net savings	-4.4	-6.0	-8.9	-11.1	-9.3	-8.3
Fiscal sector (in percent of GDP)						
General government fiscal balance 2/ 3/	-2.7	-1.3	-1.5	-1.9	-1.2	-0.4
Revenues	31.9	33.4	33.8	34.5	34.8	34.7
Expenditures 3/	34.5	34.8	35.2	36.4	36.0	35.1
Of which: Non-interest	33.5	33.9	34.5	35.6	35.5	34.6
Interest	1.0	0.8	0.8	0.8	0.5	0.5
Gross public sector debt 4/	19.4	18.6	18.2	17.3	15.6	14.6
Of which: Foreign currency denominated	13.7	13.2	14.7	13.9	12.5	11.7
External sector (in percent of GDP, unless otherwise specified)						
Trade balance for goods	-10.6	-11.3	-14.1	-14.2	-12.6	-11.0
Current account balance						
in percent of GDP	-7.7	-7.1	-10.8	-13.0	-10.5	-8.8
in billions of U.S. dollars	-1.7	-1.8	-3.2	-5.0	-5.0	-4.8
Exports of goods and services (volume change, in percent)	4.4	17.7	12.2	5.2	13.0	9.1
Imports of goods and services (volume change, in percent)	14.9	17.2	13.8	9.1	11.2	7.2
Foreign direct investment, net	2.3	2.7	5.2	4.4	3.8	3.6
Gross official reserves (in billions of U.S. dollars)	3.6	3.8	5.8	7.0	8.1	9.2
Reserve cover of short-term debt at remaining maturity	0.5	0.6	0.6	0.6	0.7	0.8
Gross external debt	47.3	49.3	64.1	65.8	64.2	64.1
Short-term debt at original maturity	16.7	18.9	19.1	17.1	15.7	16.7
Exchange rates						
Exchange rate (litas/U.S. dollar, end of period)	2.5	2.9	2.6	2.5	2.3	2.3
Exchange rate (litas/euro, end of period)	3.5	3.5	3.5	3.5	3.5	3.5
Real effective exchange rate (2000=100, increase=appreciation) 5/	104.9	103.2	103.5	106.9	106.9	106.9
Money and credit						
Reserve money (year-on-year change, in percent)	7.1	27.6	19.3	21.1	14.8	10.9
Broad money (year-on-year change, in percent)	21.4	31.9	21.5	22.1	15.7	12.7
Private sector credit (year-on-year change, in percent)	40.3	56.1	51.4	45.3	20.1	15.6
Money multiplier	3.2	3.3	3.4	3.4	3.4	3.5
Currency/deposits (in percent)	29.7	26.2	25.4	22.8	20.5	18.4

Sources: Lithuanian authorities; and IMF staff estimates and projections.
1/ Based on labor force data.
2/ The figures for 2003 include the early repurchase of Lithuania's EFF by the BoL in net lending.
3/ Includes restitution payments for savings and property.
4/ General government debt, excluding guarantees.
5/ CPI-based, 2000 trade-weighted real effective exchange rate against 17 major trading partners.

Table 2. Lithuania: Demand Components of GDP, 2003-07

	2003	2004	2005	2006	2007
	(Year-on-year growth in percent)				
Real GDP	10.3	7.3	7.9	7.7	8.8
Consumption	8.7	11.2	10.1	10.5	9.7
Investment	24.6	18.7	2.0	3.9	14.7
Of which: Gross fixed investment	23.6	21.5	-0.4	4.7	15.3
Property-related	20.6	14.9	3.1	5.9	...
Exports of goods and services	6.9	4.4	17.7	12.2	5.2
Imports of goods and services	10.4	14.9	17.2	13.8	9.1
	(Contribution to growth, in percent)				
GDP	10.3	7.3	7.9	7.7	8.8
Consumption	7.2	9.1	8.5	9.0	8.6
Investment	5.6	4.8	0.6	1.0	3.8
Of which:					
Gross fixed investment	5.0	5.1	-0.1	1.2	3.9
Of which: Property-related	2.2	1.7	0.4	0.7	...
Change in inventories	0.7	-0.2	0.7	-0.1	0.1
Net exports	-2.5	-6.8	-1.9	-2.9	-3.8
Exports of goods and services	3.9	2.4	9.5	7.1	3.1
Imports of goods and services	-6.4	-9.2	-11.4	-10.0	-6.9

Sources: Bank of Lithuania; Statistics Lithuania; and IMF staff estimates.
1/ Includes restitution payments in expenditures.

Table 3. Lithuania: Net International Investment Position, 2002-07
(in percent of GDP)

	2002	2003	2004	2005	2006	2007Q3
Lithuania	-32.8	-33.4	-34.6	-43.2	-49.7	-53.7
Assets	26.9	27.8	30.0	37.2	43.2	41.6
Of which: short-term	20.9	22.0	21.6	24.0	27.7	25.0
Liabilities	59.7	61.1	64.6	80.4	92.9	95.2
Of which: short-term	12.2	14.7	14.9	19.6	17.9	16.5
Government and Monetary Authorities 1/	1.7	4.0	2.6	4.4	5.8	5.8
Assets	15.4	16.8	14.6	15.6	18.6	16.8
Of which: short-term	15.4	16.8	14.6	15.6	18.5	16.8
Liabilities	13.7	12.8	12.0	11.2	12.8	11.0
Of which: short-term	0.0	0.2	0.3	0.4	0.3	0.0
Corporates	-28.0	-28.3	-28.7	-32.6	-35.0	-34.0
Assets	6.8	6.4	7.8	10.8	11.9	13.1
Of which: short-term	1.6	1.4	1.1	0.9	1.0	0.9
FDI	0.4	0.5	1.7	2.4	2.8	3.2
Liabilities	34.8	34.7	36.5	43.5	47.0	47.2
Of which: short-term	7.9	7.7	7.7	8.6	7.6	7.1
FDI	20.3	20.3	22.1	29.4	29.7	29.4
Banks	-6.6	-9.0	-8.5	-14.9	-20.5	-25.5
Assets	4.7	4.6	7.6	10.8	12.7	11.7
Of which: parent banks	...	...	...	10.1	11.8	11.0
Short-term	3.9	3.8	6.0	7.5	8.3	7.4
FDI	0.0	0.0	0.1	0.6	0.6	0.5
Liabilities	11.3	13.6	16.1	25.7	33.2	37.1
Of which: parent banks	...	5.4	6.5	13.2	17.3	19.6
Short-term	4.3	6.8	7.0	10.6	10.0	9.3
FDI	5.1	3.8	3.7	4.1	5.6	6.0

Sources: Bank of Lithuania, and IMF staff estimates.
1/ All reserves attributed to monetary authorities.

Table 4. Lithuania: Indicators of External and Financial Vulnerability, 2004-07

	2004	2005	2006	2007 Proj.	Latest Actual	Date of Observation
Financial indicators						
Broad money (year-on-year change in percent)	21.4	31.9	21.5	22.1	22.8	Jan. 2008
Broad money in percent of gross official reserves	249.4	268.7	239.7	242.6	241.1	Jan. 2008
Private sector credit (year-on-year change in percent)	40.3	56.1	51.4	45.3	43.8	Jan. 2008
External indicators						
Current account balance in percent of GDP	-7.7	-7.1	-10.8	-13.0	-12.3	Q3 2007
Exports of GNFS (in billions of U.S. dollars)	11.7	14.9	17.8	21.4	5.7	Q3 2007
Exports of GNFS (year-on-year change in percent)	23.2	26.6	19.5	20.3	23.2	Q3 2007
Imports of GNFS (year-on-year change in percent)	25.3	25.7	24.8	23.5	21.8	Q3 2007
Capital and financial account balance in percent of GDP	6.3	10.0	16.8	18.2	21.4	Q3 2007
Gross official reserves (in billions of U.S. dollars) 1/	3.6	3.8	5.8	7.0	6.5	Q3 2007
Gross official reserves/short-term debt 2/	0.5	0.6	0.6	0.6	0.4	Q3 2007
Gross official reserves/short-term debt 3/	1.0	0.8	1.0	1.1	0.9	Q3 2007
Gross official reserves/reserve money	128.0	122.8	140.2	139.7	152.0	Jan. 2008
Gross official reserves in months of imports of GNFS over the	2.6	2.2	2.7	2.6	2.4	Q3 2007
Total gross external debt (in billions of U.S. dollars)	10.6	12.7	19.1	25.2	25.8	Q3 2007
in percent of GDP	47.3	49.3	64.1	65.8	67.3	Q3 2007
of which: Public sector debt (in billions of U.S. dollars)	3.1	2.9	4.0	4.7	3.9	Q3 2007
in percent of GDP	13.9	11.2	13.4	12.3	10.2	Q3 2007
of which: Short-term external debt (in billions of U.S. dollars) 3/	3.8	4.9	5.7	6.5	7.3	Q3 2007
in percent of GDP	16.7	18.9	19.1	17.1	19.0	Q3 2007
Total net external debt (in billions of U.S. dollars) 4/	3.3	4.0	6.3	10.9	10.7	Q3 2007
in percent of GDP	14.6	15.4	21.1	28.5	27.8	Q3 2007
of which: Public sector debt (in billions of U.S. dollars)	3.0	2.7	3.9	4.7	3.8	Q3 2007
in percent of GDP	13.2	10.7	13.1	12.3	10.0	Q3 2007
Total net external short-term debt (in billions of U.S. dollars) 5/	1.4	2.1	2.5	3.2	3.6	Q3 2007
in percent of GDP	6.4	8.4	8.4	8.5	9.4	Q3 2007
Real effective exchange rate (year-on-year change in percent, "+" = appreciation) 7/	-0.2	-1.7	0.3	3.4	3.4	2007
Financial market indicators						
Stock market index, end of period 8/	289	449	493	514	482	March 17, 2008
Foreign currency debt rating 9/	A-	A	A	A	A-	March 17, 2008
Memorandum item:						
Nominal exchange rate (litai/U.S. dollar, end-of-period)	2.9	2.9	2.6	2.4	2.2	March 17, 2008
Nominal exchange rate (litai/euro, end-of-period)	3.5	3.5	3.5	3.5	3.5	March 17, 2008

Sources: Bank of Lithuania, Ministry of Finance, Department of Statistics, National Stock Exchange of Lithuania, Bloomberg, Information Notice System, and IMF International Financial and Trade Statistics.

1/ Gross official reserves reported here differ from the monetary table due to valuation differences.

2/ On an remaining maturity basis, estimated as short-term debt at year-end plus amortization of medium- and long-term debt of the following year.

3/ On an original maturity basis.

4/ Gross external debt minus debt securities held abroad and other investments abroad.

5/ Short-term gross external debt excluding trade credits and currency and deposits held abroad.

6/ Debt service comprises interest and repayment on external loans, and interest and repayment on debt securities.

7/ CPI-based REER against the 17 major trading partners in 2000.

8/ VILSE index.

9/ S&P foreign currency sovereign rating.

Table 5. Lithuania: Summary of Monetary Accounts, 2004-09
(In billions of litai; unless otherwise specified)

	2004	2005	2006	2007	2008	2009
					Projection	
Monetary Authority						
Net foreign assets	9.0	10.9	14.7	17.0	19.6	22.0
Net domestic assets	-1.9	-2.0	-4.1	-4.1	-4.8	-5.6
Reserve money	7.0	8.9	10.7	12.9	14.8	16.4
Currency outside the central bank	5.6	6.7	8.0	9.2	9.5	9.9
Deposit money banks' deposits	1.4	2.2	2.6	3.7	5.3	6.5
Private and non monetary financial institutions	0.0	0.0	0.0	0.0	0.0	0.0
Banking Survey						
Net foreign assets	6.5	3.6	3.1	-3.9	-7.2	-10.8
Monetary authority	9.0	10.9	14.7	17.0	19.6	22.0
Banks and other banking institutions	-2.4	-7.3	-11.6	-20.8	-26.8	-32.8
Net domestic assets	15.8	25.9	32.7	47.6	57.8	67.8
Net claims on government 1/	0.6	1.6	-0.4	-2.3	-2.7	-2.7
Monetary authority	-1.5	-1.4	-3.4	-3.0	-3.4	-3.9
Banks and other banking institutions	2.1	3.0	3.0	0.7	0.6	1.1
Credit to private sector	16.3	25.5	38.5	56.0	67.3	77.8
Credit to non-bank financial institutions	1.7	4.0	2.9	3.2	3.8	4.3
Other items, net	-2.8	-5.2	-8.3	-9.3	-10.5	-11.5
Broad money	22.4	29.5	35.8	43.7	50.6	57.0
Currency outside banks	5.1	6.1	7.2	8.1	8.6	8.9
Deposits	17.2	23.4	28.6	35.6	42.0	48.2
In national currency	13.0	17.3	22.7	28.3	33.7	39.0
In foreign currency	4.2	6.1	5.9	7.3	8.3	9.1
Memorandum items:						
Reserve money (yearly percent change)	7.1	27.6	19.3	21.1	14.8	10.9
Broad money (yearly percent change)	21.4	31.9	21.5	22.1	15.7	12.7
Private sector credit (yearly percent change)	40.3	56.1	51.4	45.3	20.1	15.6
Money multiplier	3.2	3.3	3.4	3.4	3.4	3.5
Velocity of broad money	2.8	2.4	2.3	2.2	2.2	2.2
Excess reserve coverage (in percent of deposits)	11.4	8.7	15.0	14.4	13.9	13.9

Sources: Bank of Lithuania; and Fund staff estimates and projections.
1/ Excludes local government deposits; includes counterpart funds.

Table 6. Lithuania: Savings and Investment, 2004-13
(In percent of GDP)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
				Est.			Projection			
Gross national saving	16.9	17.8	16.6	16.2	17.3	17.9	18.0	18.0	18.1	18.1
General government	0.6	2.1	2.6	2.5	3.2	3.2	3.5	3.6	3.6	3.6
Nongovernment	16.3	15.7	14.0	13.7	14.1	14.6	14.4	14.4	14.4	14.5
Gross national investment	24.0	25.1	27.0	29.2	27.7	26.6	26.5	26.3	26.1	26.1
General government	3.2	3.4	4.1	4.4	4.4	3.6	3.7	3.6	3.6	3.6
Nongovernment	20.7	21.7	22.9	24.8	23.3	23.0	22.8	22.8	22.5	22.5
Foreign saving 1/	7.1	7.3	10.4	13.0	10.5	8.8	8.6	8.3	8.0	8.0

Sources: Lithuanian authorities; and IMF staff estimates and projections.
1/ Negative current account balance.

Table 7. Lithuania: Balance of Payments, 2004-13
(In percent of GDP; unless otherwise specified)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
				Est.	Projection					
Current account	-7.7	-7.1	-10.8	-13.0	-10.5	-8.8	-8.6	-8.3	-8.0	-8.0
Trade balance of goods and services	-7.0	-7.3	-10.5	-11.6	-9.6	-7.8	-7.5	-6.9	-6.8	-6.9
Trade balance, goods	-10.6	-11.3	-14.1	-14.2	-12.6	-11.0	-10.9	-10.5	-10.4	-10.5
Trade balance, services	3.6	4.1	3.6	2.6	3.0	3.2	3.3	3.6	3.7	3.7
Factor income, net	-2.7	-2.4	-2.7	-4.5	-4.2	-4.1	-4.1	-4.2	-4.2	-3.9
Current transfers, net	2.0	2.6	2.4	3.0	3.3	3.2	3.1	2.8	2.9	2.8
Capital and financial account	6.3	10.0	16.8	18.2	12.8	10.7	10.3	9.9	10.0	9.6
Capital transfers	1.3	1.3	1.2	1.6	1.7	1.6	1.6	1.4	1.5	1.5
Financial account	5.0	8.7	15.7	16.7	11.1	9.1	8.8	8.5	8.5	8.1
Direct investment, net	2.3	2.7	5.2	4.4	3.8	3.6	3.3	3.1	3.0	2.6
Portfolio investment, net	0.9	-0.9	-0.9	-0.8	-0.1	-0.8	-0.9	-1.2	-1.1	-1.1
Other investment, net	1.8	6.9	11.3	13.1	7.4	6.3	6.4	6.5	6.6	6.5
Errors and omissions	0.9	-0.2	-1.0	-1.8	0.0	0.0	0.0	0.0	0.0	0.0
Reserve buildup	0.6	-2.7	-5.1	-3.2	-2.3	-1.9	-1.8	-1.6	-2.0	-1.6
Memorandum items:										
Gross official reserves (in billions of U.S. dollars)	3.6	3.8	5.8	7.0	8.1	9.2	10.2	11.3	12.7	14.0
Exports of GNFS (nominal percent change, y-o-y)	23.2	26.6	19.5	20.3	30.0	14.5	12.1	12.4	10.9	10.1
Of which: Non-oil exports of GNFS	15.8	24.2	23.5	25.8	28.7	15.8	13.0	13.3	11.6	10.6
Imports of GNFS (nominal percent change, y-o-y)	25.3	25.7	24.8	23.5	25.7	11.2	11.5	11.1	10.6	10.3
Of which: Non-oil imports of GNFS	22.9	17.8	27.9	29.4	20.5	12.6	13.0	12.3	11.6	11.1
USD Exchange Rate (period average)	2.8	2.8	2.8	2.5	2.3	2.3	2.3	2.3	2.3	2.2
Reserve cover of short-term external debt 1/	0.5	0.6	0.6	0.6	0.7	0.8	0.8	0.9	0.9	0.9
Net international investment position	-34.6	-43.2	-49.7	-52.4	-56.9	-58.8	-60.7	-62.6	-64.5	-66.4

Sources: Data provided by the Lithuanian authorities; IMF International Financial and Trade Statistics; and IMF staff estimates and projections.
1/ Short-term debt at remaining maturity.

Table 8. Lithuania: General Government Operations, 2005-13
(in percent of GDP; unless otherwise specified)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
				Est.	Projection					
Revenue	31.9	33.4	33.8	34.5	34.8	34.7	34.9	34.7	34.9	34.8
Tax revenue	19.8	20.2	20.9	21.2	21.3	21.2	21.3	21.3	21.4	21.4
Taxes on income and profits	8.7	9.1	9.7	9.5	8.8	8.8	8.8	8.8	8.8	8.9
Income tax	6.8	6.9	6.9	7.0	6.6	6.6	6.6	6.6	6.6	6.6
Corporate profit tax	1.9	2.1	2.8	2.5	2.2	2.2	2.2	2.2	2.2	2.2
Taxes on goods and services	10.5	10.8	10.9	11.4	12.1	12.0	12.1	12.1	12.2	12.2
VAT	6.4	7.1	7.6	8.0	8.5	8.5	8.5	8.5	8.6	8.6
Excises	3.0	3.0	3.0	3.0	3.2	3.2	3.2	3.2	3.2	3.2
Other	1.1	0.8	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Other tax revenue	0.6	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.3
Social security contributions	9.2	9.0	9.3	9.4	9.5	9.5	9.6	9.6	9.6	9.6
Grants	0.9	1.0	1.3	1.7	1.8	1.7	1.9	1.6	1.7	1.6
Other revenue	2.0	3.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Expense	32.4	32.7	32.4	33.3	32.8	32.7	32.7	32.4	32.5	32.4
Wages and salaries, incl. contributions to SoDra	8.9	10.0	10.1	9.9	10.1	10.1	10.1	10.1	10.1	10.1
Goods and services	4.7	5.7	5.8	5.7	5.7	5.7	5.7	5.7	5.7	5.8
Grants	0.5	0.8	0.8	0.7	0.8	0.8	0.8	0.8	0.8	0.8
Subsidies	0.7	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Interest payments	1.0	0.8	0.8	0.8	0.5	0.5	0.7	0.7	0.7	0.6
Foreign	0.7	0.6	0.6	0.6	0.3	0.3	0.5	0.5	0.4	0.4
Domestic	0.3	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Social benefits	12.5	10.5	10.9	11.4	12.1	12.1	12.2	12.1	12.2	12.1
Other expense (incl. restitution payments)	4.1	4.0	3.4	3.9	2.9	2.7	2.4	2.3	2.3	2.3
Of which: Savings and Property Restitution	1.1	0.8	0.9	1.4	0.4	0.2	0.2	0.0	0.0	0.0
Net acquisition of nonfinancial assets	2.2	2.1	2.8	3.2	3.2	2.4	2.5	2.3	2.4	2.3
Net lending/borrowing (borrowing (-))	-2.7	-1.3	-1.5	-1.9	-1.2	-0.4	-0.2	0.0	0.0	0.0
Memorandum items:										
GDP (in millions of litai)	62.6	71.4	81.9	96.8	113.0	127.3	139.9	151.6	165.3	179.3
General government balance (excl. restitution payments)	-1.5	-0.5	-0.6	-0.5	-0.8	-0.2	0.0	0.0	0.0	0.0
General government debt	19.4	18.6	18.2	17.3	15.6	14.6	13.8	13.0	12.2	11.5
Foreign debt	11.9	11.2	12.5	11.6	10.7	10.0	9.4	8.9	8.3	7.9
Domestic debt	7.5	7.5	5.8	5.7	4.9	4.6	4.4	4.1	3.9	3.6
Cyclically adjusted general government balance (incl. restitution payments)	-3.7	-2.5	-2.6	-3.2	-2.3	-1.2	-0.7	-0.3	0.0	0.2
Output gap (in percent of potential GDP)	3.2	3.7	3.8	4.5	4.0	3.0	1.9	0.8	0.0	-0.1

Sources: Ministry of Finance; Ministry of Social Security; and IMF staff estimates.

Table 9. Lithuania: Financial Sector Indicators, 2004-08

(In percent, unless otherwise indicated)

	2004	2005	2006	2007	Jan 2008
Private sector credit (year-on-year change) 1/	40.3	56.1	51.4	45.3	43.8
Claims on private enterprises (in billions of litas)	11.3	16.1	22.7	31.0	31.3
of which: share of foreign currency loans	64.8	67.9	58.2	58.8	60.4
Claims on private enterprises (year-on-year change)	24.6	42.6	41.1	36.5	55.2
Share of claims on private enterprises in total private sector credit	69.2	63.2	58.9	55.3	55.2
Claims on individuals (in billions of litas)	5.0	9.4	15.8	25.0	25.4
of which: share of foreign currency loans	42.8	54.7	43.9	49.8	52.4
Claims on individuals (year-on-year change)	96.0	86.6	69.2	58.0	55.2
Share of claims on individuals in total private sector credit	30.8	36.8	41.1	44.7	44.8
Share of foreign currency loans	58.0	63.1	52.3	54.8	56.8
Financial sector risk factors of deposit money banks					
Share of foreign currency private sector credit in total private sector	58.0	63.1	52.3	54.8	56.8
Share of foreign currency deposits in total deposits	27.0	28.0	22.4	22.5	23.9
Short-term private sector credit in percent of total private sector credit	81.1	84.5	86.2	86.2	86.1
Demand deposits in percent of total deposits	43.3	38.3	40.7	46.7	50.8
Total private sector credit (in billions of litai) 2/	16.3	25.5	38.5	56.0	56.8
Total resident deposits (in billions of litai) 2/	17.2	23.4	28.6	35.6	35.1
Average annual interest rate on litas loans to enterprises	5.7	5.0	5.0	7.9	8.6
Average annual interest rate on litas loans to households	6.4	5.8	5.2	8.4	8.7

Sources: Bank of Lithuania and National Stock Exchange of Lithuania.

1/ Includes credit to private enterprises, households, and nonprofit institutions by monetary authorities, deposit money banks, and other banking institutions.
2/ From banking survey, including monetary authorities, deposit money banks, and other banking institutions.

Table 10. Lithuania: Financial Soundness Indicators, 2000-07
(In percent, unless otherwise specified)

	2003	2004	2005	2006	2007
Capital adequacy					
Regulatory capital to risk-weighted assets [1]	13.2	12.4	10.3	10.7	10.9
Regulatory tier I capital to risk-weighted assets [1]	11.1	10.2	8.9	7.8	7.7
Capital to assets [2]	9.8	8.7	7.2	7.1	7.4
Asset quality					
Nonperforming loans net of provisions to capital [2, 3, 7]	11.7	12.6	5.7	9.7	10.4
Nonperforming loans to total (non-interbank) loans [7]	2.4	2.2	0.6	1.0	1.0
Sectoral distribution of loans to total loans [8]					
Agriculture, hunting, forestry	1.8	2.0	2.0	1.9	1.7
Fishing	0.1	0.1	0.1	0.1	0.0
Mining and quarrying	0.3	0.2	0.2	0.1	0.1
Manufacturing	21.8	17.5	15.2	11.9	9.9
Electricity, gas and water supply	7.6	6.4	4.2	2.5	2.2
Construction	3.2	2.9	3.9	5.7	4.1
Wholesale and retail trade; repair of motor vehicles, motorcycles; personal and ho	19.2	15.7	13.0	12.8	10.7
Hotels and restaurants	1.7	1.6	1.5	1.6	1.4
Transport, storage and communication	2.9	2.3	2.6	2.5	2.2
Financial intermediation	10.7	10.8	14.6	7.3	5.5
Real estate, renting and other business activities	7.6	9.8	12.5	14.5	16.8
Public administration and defence; compulsory social security	2.4	4.1	3.3	1.5	1.3
Education	0.1	0.1	0.1	0.0	0.0
Health and social work	0.6	0.8	0.5	0.3	0.3
Other utilities, social and personal services	1.1	0.9	0.7	0.9	0.9
Other types of economic activities	0.0	0.0	0.0	0.0	0.0
Loans not attributed to economic activities	18.9	24.9	25.8	36.4	42.9
Residential real estate loans to total (non-interbank) loans	14.3	18.4	21.2	24.7	27.8
All large exposures to regulatory capital [1, 5]	213.1	199.6	239.0	189.6	152.5
Earnings and profitability					
Return on equity (Net income to average capital) [2, 4]	11.4	13.5	13.8	21.4	27.2
Return on assets (Net income to average total assets) [4]	1.2	1.3	1.1	1.5	2.0
Interest margin to gross income	49.1	51.0	53.8	54.6	57.8
Noninterest expenses to gross income	81.6	70.9	66.6	58.7	52.6
Trading and foreign exchange gains (losses) to gross income	10.3	8.1	7.8	8.5	7.6
Personnel expenses to noninterest expenses	38.3	37.3	37.4	37.6	39.3
Spread between reference lending and reference deposit rate	4.2	3.6	3.3	3.5	4.1
Liquidity					
Liquid assets to total assets	27.7	28.3	26.9	24.1	21.9
Liquid assets to current liabilities	42.4	41.7	42.9	41.9	43.5
Spread between highest and lowest interbank rate	3.9	1.7	3.3	2.8	6.1
Customer deposits to total non-interbank loans	101.7	95.7	83.3	72.5	61.3
Foreign exchange risk					
Foreign-currency-denominated loans to total (non-interbank) loans [6]	54.6	58.3	65.8	52.8	55.6
Foreign-currency-denominated liabilities to total liabilities [6]	46.1	45.6	51.6	52.0	56.4
Net open position in foreign exchange to regulatory capital [1]	10.8	-1.9	-1.0	-1.4	-2.4
Equity risk and exposure to derivatives					
On balance (assets) position in equities to capital [2]	12.2	12.2	14.9	13.2	8.6
Gross assets position in financial derivatives to capital [2]	0.5	0.8	1.2	4.5	9.7
Gross liabilities position in financial derivatives to capital [2]	2.1	0.8	0.7	4.9	7.6

Source: Bank of Lithuania.

Note: FSI are on bank entity bases only and cover all banks operating in Lithuania, including foreign bank branches.
1/ Without foreign bank branches.
2/ Capital is defined as banks shareholders' equity and foreign bank branches funds received from the head office.
3/ From end-2005 FSI is Nonperforming loans to capital.
4/ Net income before extraordinary items and taxes.
5/ Large exposure - means loans granted to the borrower the net value of which equals to, or exceeds, 10 per cent of bank capital.
6/ From 2005 The major part of foreign currency loans and foreign currency liabilities are in Euros.
7/ From end-2005 NPLs are loans with payments on which are overdue more than 60 days. Untill 2004 NPLs are loans in Substandard, Doubtful and Loss loans categories.
8/ Credit registry data from 2005, therefore, it is considered as estimate of actual sectoral distribution.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LITHUANIA

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by the European Department

April 1, 2008

Contents | Page

APPENDIX I. LITHUANIA: FUND RELATIONS
(As of February 29, 2008)

Mission: February 7–20, 2008. The concluding statement of the mission is available at http://www.imf.org/external/np/ms/2008/021908.htm.

Staff team: Mr. Morsink (head), Ms. Ohnsorge, and Mr. Obiora (all EUR), and Ms. Khamis (MCM). Mr. Sierhej, Regional Representative Office, Warsaw, joined the mission during February 7–15. Mr. Abazorious (from the Executive Director's office) also joined the mission.

I. Membership Status: Joined April 29, 1992; Article VIII.

II. General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	144.20	100.00
Fund holdings of currency	144.18	99.99
Reserve position	0.03	0.02

III. SDR Department:	**SDR Million**	**Percent of Allocation**
Holdings	0.07	N/A

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	8/30/2001	3/29/2003	86.52	0.00
Stand-by	3/8/2000	6/7/2001	61.80	0.00
EFF	10/24/1994	10/23/1997	134.55	134.55

VI. Projected Payments to Fund: None

VII. Implementation of HIPC Initiative: Not applicable.

VIII. Implementation of MDRI Assistance: Not applicable.

IX. Current Status of Safeguards Assessments:

Under the Fund's safeguards assessment policy, Bank of Lithuania (BOL) was subject to an assessment with respect to the Stand-By Arrangement, which was approved on August 30, 2001 and expired on March 29, 2003. A safeguards assessment of the BOL was completed on December 10, 2001. The assessment identified certain weaknesses and proposed appropriate recommendations as reported in the IMF Country Report No. 01/160. The BOL has decided to implement these recommendations under a timetable agreed with the Fund.

X. Exchange Arrangements:

The currency of Lithuania is the litas. From April 1, 1994 to February 1, 2002, the litas was pegged to the U.S. dollar at LTL 4 per U.S. dollar under a currency board arrangement. Since February 2, 2002 the litas has been pegged to the euro at LTL 3.4528 per euro. Lithuania joined the European Union (EU) on May 1, 2004, and ERM II on June 28, 2004. Lithuania has accepted the obligations of Article VIII of the Fund's Article of Agreement and maintains an exchange system free of restrictions on the making of payment and transfers for current international transactions except for those maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

XI. Article IV Consultation:

Lithuania is on the 12-month consultation cycle. The last Article IV consultation was concluded on March 26, 2007. The Executive Board assessment is available at http://www.imf.org/external/np/sec/pn/2007/pn0743.htm and the staff report and other mission documents at http://www.imf.org/external/pubs/cat/longres.cfm?sk=20625.0. Lithuania has accepted the obligations of Article VIII and maintains an exchange rate system free of restrictions on the making of payments and transfers on current international transactions except for those maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

XII. FSAP Participation and ROSCs:

FSAP Update mission was completed on November 19, 2007. Fiscal and statistics ROSCs were completed in November 2002 and December 2002, respectively.

XII. Technical Assistance:

The table on the following page summarizes the technical assistance missions provided by the Fund to Lithuania since February 1997.

XIII. Resident Representative: Christoph Rosenberg (stationed in Warsaw, Poland).

XIV. Anti-money laundering and combating financing of terrorism:

In 2006, MONEYVAL evaluated Lithuania's anti-money laundering (AML) and combating the financing of terrorism (CFT) system and concluded that the system was quite sound on paper. However, the report raised questions about the implementation of AML/CFT measures. A draft law on the Prevention of Money Laundering has been circulated to the relevant authorities for their comments.

LITHUANIA: TECHNICAL ASSISTANCE FROM THE FUND, 1997–2008

Department	Issue	Action	Date	Counterpart
FAD	Treasury operations	Mr. Ramachandran	Feb/Mar. 1997	Ministry of Finance
FAD	Treasury operations	Mr. Ramachandran	Jun. 1997	Ministry of Finance
FAD	Treasury operations	Mr. Ramachandran	Aug/Sep. 1997	Ministry of Finance
STA	Balance of payments statistics	Mr. Allen	Aug/Sep. 1997	Department of Statistics
FAD	Treasury operations	Mr. Ramachandran	Nov/Dec. 1997	Ministry of Finance
MAE	Monetary policy and banking supervision	Mission	Dec. 1997	Bank of Lithuania
STA	National accounts and balance of payments	Mr. Gschwindt de Gyor	Dec. 1997	Department of Statistics
FAD	Treasury operations	Mr. Ramachandran	Jan. and April 1998	Ministry of Finance
STA	Multipurpose statistics	Mr. Allen	Resident Advisor, 1997-98	Department of Statistics, Bank of Lithuania, and Ministry of Finance
STA	Balance of payments	Mr. Gschwindt de Gyor	April 1999	Department of Statistics and Bank of Lithuania
FAD	Expenditure policy	Mission	June/July 99	Ministry of Finance
FAD	Treasury operations	Mission	November 1999	Ministry of Finance
MAE	Monetary policy	Mr. Ketterer	Resident Advisor, May 1997-November 1999	Bank of Lithuania
STA	Balance of payments statistics (also covering Latvia)	Mr. Buxton	Resident Advisor, October 1999–October 2000	Bank of Lithuania
LEG	Bankruptcy legislation	Mr. Dimitrachkov	March 2000	Ministry of Economy
FAD	Establishment of Fiscal Reserve Fund	Mission	July 2000	State Privatization Fund
MAE	Multi-topic	Mission	March 2001	Bank of Lithuania
FAD	Tax policy issues	Mission	June 13-26, 2001	Ministry of Finance
STA	ROSC	Mission	May 8-22, 2002	Department of Statistics, Ministry of Finance, and Bank of Lithuania
FAD	ROSC	Mission	July 10-23, 2002	Ministry of Finance
FAD	Treasury Operations	Mr. Ramachandran	Nov 22-Dec 5 2004	Ministry of Finance
FAD	Decentralization	Mission	Dec 3-Dec 15 2004	Ministry of Finance
STA	External debt statistics	Mission	Aug 2-4, 2006	Bank of Lithuania
MCM	Stress testing	Mission	June 11-21, 2007	Bank of Lithuania
STA	External debt statistics	Mission	November 8-19, 2007	Bank of Lithuania

APPENDIX II. LITHUANIA: STATISTICAL ISSUES

Over the past several years, Lithuania has made good progress in establishing a macroeconomic database. Official data for all sectors are adequate for surveillance purposes.

Lithuania subscribed to the Special Data Dissemination Standard (SDDS) in May 1996, and its metadata have been posted on the Fund's Dissemination Standards Bulletin Board (DSBB) since April 1997. Lithuania meets the SDDS specifications for coverage, periodicity and timeliness of the data, and for the dissemination of the advance release calendars. A significant amount of economic and financial information is now available on various websites through the Internet (see section on Dissemination of Statistics, below). A ROSC data module was published in November 2002.

National Accounts

The national accounts are compiled by Statistics Lithuania (SL) (the former Department of Statistics) in accordance with the guidelines of the *European System of Accounts 1995* (*ESA 95*). Quarterly GDP estimates at current and at constant prices are compiled using both the production and expenditure approaches. GDP estimates by production are considered to be more reliable than the corresponding estimates by expenditure, but no statistical discrepancies between these two estimates are shown in the published figures as the discrepancies are included in the estimates of changes in inventories. In general, good data sources and sound methods are used, for the compilation of the national accounts, but difficulties remain in measuring the economic activity of the informal sector. These latter estimates are compiled at detailed levels of economic activity using fixed coefficients derived from a benchmark survey conducted in 1996. The annual and the quarterly national accounts are compiled at previous year prices and chain-linked to 2000.

Price Data

Since December 1998, CPI weights have been updated annually. The monthly CPI is available in the second week following the reference month. The producer price index is calculated according to the chain-linked Laspeyres formula with weights updated every year.

Public Finance

Data on the central government budget execution are available quarterly, although these data are subject to frequent revisions. The ongoing treasury project is expected to improve fiscal data quality substantially. However, further work is needed to clarify the treatment of public health care providers and of EU transactions, and the consolidation procedure for government operations. A new classification, incorporating the *GFSM2001* was approved in mid-2003. Since then, the MoF has been reporting to STA general government's annual data on an accrual and cash basis (except for local governments, which are still on a cash basis) for publication in the *Government Finance Statistics Yearbook* (GFSY). In addition, the MoF has been reporting quarterly and monthly data in the GFSM 2001 format for publication in the IFS.

Monetary and Financial Statistics

The Bank of Lithuania (BoL) reports monetary and financial statistics (MFS) to STA on a timely and regular basis. The scope, concepts and definitions of the MFS are broadly in line with the guidelines of the *Monetary and Financial Statistics Manual (MFSM)*. Following Lithuania's accession to the European Union, the BoL implemented the ECB framework for compiling and reporting monetary data reflecting the ECB regulations (*1995 ESA*) on sectorization, valuation and classification of financial instruments.

External Sector

The BoL is responsible for compiling balance of payments, international investment position (IIP), external debt and international reserves statistics. The BoL reports quarterly data on balance of payments, IIP and monthly international reserves to STA on a timely and regular basis. Balance of payments data (on a monthly and quarterly basis) are compiled using the format recommended in the *Balance of Payments Manual*, fifth edition (*BPM5*). The monthly data correspond to several key balance of payments components, compiled on the basis of a sample survey covering the public sector, commercial banks, and some nonfinancial private sector institutions. The Data Template on International Reserves and Foreign Currency Liquidity is disseminated monthly according to the operational guidelines and is hyperlinked to the Fund's DSBB. Since late 2004, the BoL disseminates quarterly external debt data in the World Bank's Quarterly External Debt Statistics (QEDS) database.

Dissemination of Statistics

The authorities publish a range of economic statistics through a number of publications, including the SL's monthly publication, *Economic and Social Developments,* and the BoL's monthly *Bulletin*. A significant amount of data are available on the Internet:

- metadata for data categories defined by the Special Data Dissemination Standard are posted on the IMF's DSBB (http://dsbb.imf.org);

- the BoL website (http://www.lb.lt) provides data on monetary statistics, treasury bill auction results, balance of payments, IIP, external debt and other main economic indicators;

- the SL website (http://www.stat.gov.lt) provides monthly and quarterly information on economic and social development indicators;

- the MoF (http://www.finmin.lt) home page includes data on the national budget, as well as information on laws and privatization; and

- the Vilnius Stock Exchange website (http://www.lt.omxgroup.com.?lang=en) has information on stock trading.

Table 1. Lithuania: Common Indicators Required for Surveillance

As of March 11, 2008

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	Mar 3, 08	Mar 5, 08	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Feb 29, 08	Mar. 08	M	M	M		
Reserve/Base Money	Jan 31, 08	Feb. 08	M	M	M	O, LO, LO, LO	O, O, LO, O, O
Broad Money	Jan 31, 08	Feb. 08	M	M	M		
Central Bank Balance Sheet	Jan 31, 08	Feb. 08	M	M	M		
Consolidated Balance Sheet of the Banking System	Jan 31, 08	Feb. 08	M	M	M		
Interest Rates[2]	Mar 4, 08	Mar 4, 08	M	M	M		
Consumer Price Index	Feb. 08	Mar. 08	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q3/07	Dec. 07	Q	Q	Q	LO,LO,LO,O	O,O,O,O,O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Q4/07	Feb. 07	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4/07	Feb. 08	M	M	M		
External Current Account Balance	Q3/07	Dec. 07	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	Dec. 07	Feb.08	M	M	M		
GDP/GNP	Q4/07	Feb. 08	Q	Q	Q	O, LO, O, LO	O, LO, LO, LO, O
Gross External Debt	Q3/07	Dec. 07	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).
[8] Reflects the assessment provided in the data ROSC (published on November 22, 2002, and based on the findings of the respective missions that took place during May 8-22, 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[9] Reflects the assessment provided in the data ROSC (published on November 22, 2002, and based on the findings of the respective missions that took place during May 8-22, 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

Table 2. Lithuania: External Debt Sustainability Framework, 2004-13
(In percent of GDP, unless otherwise indicated)

	Actual			Est.	Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	47.3	49.3	64.1	65.8	**64.2**	**64.1**	**65.1**	**66.3**	**67.1**	**68.2**	**-8.6**
Change in external debt	1.1	2.0	14.8	1.7	-1.6	-0.1	1.0	1.2	0.8	1.1	
Identified external debt-creating flows (4+8+9)	-3.9	-2.6	-1.5	-5.9	-7.0	-2.6	-1.2	-0.5	-1.3	-0.8	
Current account deficit, excluding interest payments	6.8	6.4	10.2	12.4	9.9	8.2	8.0	7.8	7.5	7.5	
Deficit in balance of goods and services	-7.0	-7.3	-10.5	-11.6	-9.6	-7.8	-7.5	-6.9	-6.8	-6.9	
Exports	52.2	57.8	59.7	55.8	57.8	58.4	59.2	60.8	61.2	61.4	
Imports	-59.2	-65.1	-70.2	-67.3	-67.4	-66.2	-66.7	-67.7	-67.9	-68.3	
Net non-debt creating capital inflows (negative)	-3.5	-3.8	-5.7	-4.6	-4.1	-3.8	-3.6	-3.2	-3.2	-2.9	
Automatic debt dynamics 1/	-7.3	-5.2	-6.0	-13.7	-12.8	-6.9	-5.6	-5.1	-5.6	-5.5	
Contribution from nominal interest rate	0.8	0.7	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	
Contribution from real GDP growth	-2.8	-3.3	-3.3	-4.4	-3.4	-3.1	-3.2	-3.1	-3.2	-3.5	
Contribution from price and exchange rate changes 2/	-5.3	-2.6	-3.4	-9.9	-9.9	-4.4	-3.0	-2.5	-2.9	-2.4	
Residual, incl. change in gross foreign assets (2-3) 3/	5.1	4.6	16.3	7.6	5.4	2.5	2.2	1.7	2.1	1.8	
External debt-to-exports ratio (in percent)	90.6	85.3	107.3	118.0	111.2	109.7	110.0	109.1	109.7	111.1	
Gross external financing need (in billions of US dollars) 4/	8.6	8.5	12.9	17.0	17.0	17.3	18.4	24.4	25.5	27.6	
in percent of GDP	38.3	33.2	43.2	44.4	35.4	31.7	30.6	36.9	35.0	34.6	
Scenario with key variables at their historical averages 5/					**67.4**	**65.6**	**63.7**	**61.3**	**59.6**	**57.7**	**-11.2**
Key Macroeconomic Assumptions Underlying Baseline											
Real GDP growth (in percent)	7.3	7.9	7.7	8.8	6.5	5.5	5.5	5.3	5.3	5.8	
GDP deflator in US dollars (change in percent)	13.0	5.9	7.4	18.5	17.9	7.3	4.9	4.0	4.6	3.7	
Nominal external interest rate (in percent)	2.1	1.6	1.5	1.3	1.1	1.0	0.9	0.9	0.8	0.8	
Growth of exports (US dollar terms, in percent)	23.2	26.6	19.5	20.3	30.0	14.5	12.1	12.4	10.9	10.1	
Growth of imports (US dollar terms, in percent)	25.3	25.7	24.8	23.5	25.7	11.2	11.5	11.1	10.6	10.3	
Current account balance, excluding interest payments	-6.8	-6.4	-10.2	-12.4	-9.9	-8.2	-8.0	-7.8	-7.5	-7.5	
Net non-debt creating capital inflows	3.5	3.8	5.7	4.6	4.1	3.8	3.6	3.2	3.2	2.9	
B. Bound Tests											
B1. Nominal interest rate is at historical average plus one standard deviation					**64.4**	**64.4**	**65.5**	**66.9**	**67.8**	**68.9**	**-8.3**
B2. Real GDP growth is at historical average minus one standard deviations					**63.8**	**64.6**	**66.5**	**68.5**	**70.1**	**71.8**	**-7.9**
B3. Non-interest current account is at historical average minus one standard deviations					**65.7**	**66.9**	**69.2**	**71.6**	**73.5**	**75.5**	**-9.0**
B4. Combination of B1-B3 using 1/2 standard deviation shocks					**65.4**	**66.4**	**68.5**	**70.7**	**72.5**	**74.4**	**-8.4**
B5. One time 30 percent real depreciation in 2008					**93.0**	**89.1**	**87.2**	**85.9**	**84.4**	**83.5**	**-11.2**

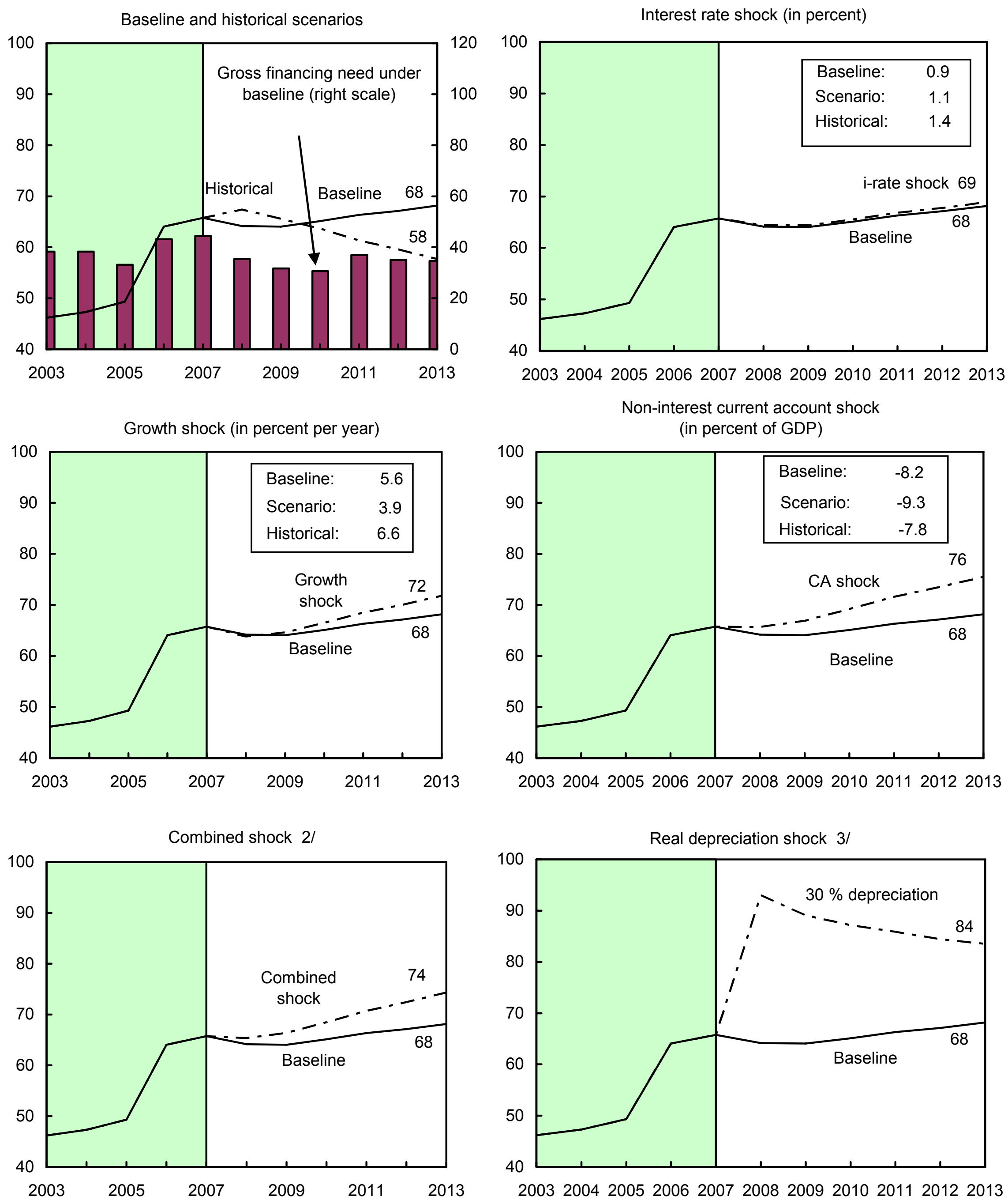
1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 3. Lithuania: Public Sector Debt Sustainability Framework, 2004-13
(In percent of GDP, unless otherwise indicated)

	Actual			Est.	Projection						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	19.4	18.6	18.2	17.3	**15.6**	**14.6**	**13.8**	**13.0**	**12.2**	**11.5**	**0.0**
o/w foreign-currency denominated	13.7	13.2	14.7	13.9	12.5	11.7	11.1	10.5	9.8	9.3	
Change in public sector debt	-1.8	-0.8	-0.4	-1.0	-1.7	-1.0	-0.8	-0.8	-0.8	-0.6	
Identified debt-creating flows (4+7+12)	1.2	1.9	-0.6	-1.5	-1.7	-1.0	-0.7	-0.7	-0.8	-0.6	
Primary deficit	1.7	0.5	0.7	1.1	0.7	-0.1	-0.5	-0.7	-0.7	-0.6	
Revenue and grants	31.9	33.4	33.8	34.5	34.8	34.7	34.9	34.7	34.9	34.8	
Primary (noninterest) expenditure	33.5	33.9	34.5	35.6	35.5	34.6	34.4	34.0	34.2	34.2	
Automatic debt dynamics 2/	-2.0	0.3	-1.7	-3.0	-2.8	-1.3	-0.7	-0.5	-0.5	-0.4	
Contribution from interest rate/growth differential 3/	-1.0	-1.6	-1.6	-2.0	-2.0	-1.2	-0.6	-0.4	-0.4	-0.3	
Of which contribution from REAL interest rate	0.4	-0.2	-0.4	-0.6	-1.0	-0.5	0.1	0.3	0.2	0.3	
Of which contribution from REAL GDP growth	-1.4	-1.4	-1.2	-1.4	-1.0	-0.8	-0.7	-0.7	-0.6	-0.7	
Contribution from exchange rate depreciation 4/	-1.1	1.9	...	...	...	...	...	...	...	...	
Other identified debt-creating flows	1.6	1.1	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	
Privatization receipts (negative)	0.7	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	1.0	0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-3.0	-2.7	0.1	-0.6	-0.9	-0.1	-0.1	-0.2	-0.2	-0.1	
Public sector debt-to-revenue ratio 1/	61.0	55.8	54.0	50.0	44.7	42.0	39.5	37.4	34.9	33.2	
Gross financing need 6/	9.3	7.0	7.0	7.0	6.0	6.0	5.6	5.1	4.9	1.2	
in billions of U.S. dollars	2.1	1.8	2.1	2.7	2.9	3.3	3.4	3.4	3.5	0.9	
Scenario with key variables at their historical averages 7/					**17.7**	**19.0**	**20.2**	**21.3**	**22.3**	**23.4**	**-0.4**
Scenario with no policy change (constant primary balance) in 2007-2012					**16.0**	**16.2**	**16.9**	**17.8**	**18.5**	**18.5**	**-1.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
Real GDP growth (in percent)	7.3	7.9	7.7	8.8	6.5	5.5	5.5	5.3	5.3	5.8	
Average nominal interest rate on public debt (in percent) 8/	5.2	4.9	4.6	5.4	3.5	3.8	5.3	5.5	5.5	5.5	
Average REAL interest rate (nominal rate minus change in GDP deflator, in percent)	2.5	-0.7	-1.9	-3.2	-6.2	-3.0	1.2	2.5	1.9	2.9	
Nominal appreciation (increase in US dollar value of local currency, in percent)	9.0	-12.9	0.8	9.1	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	2.7	5.7	6.6	8.6	9.6	6.8	4.1	3.0	3.5	2.6	
Growth of real primary spending (deflated by GDP deflator, in percent)	14.8	9.2	9.5	12.3	6.2	2.7	5.1	4.0	5.9	5.6	
Primary deficit	1.7	0.5	0.7	1.1	0.7	-0.1	-0.5	-0.7	-0.7	-0.6	

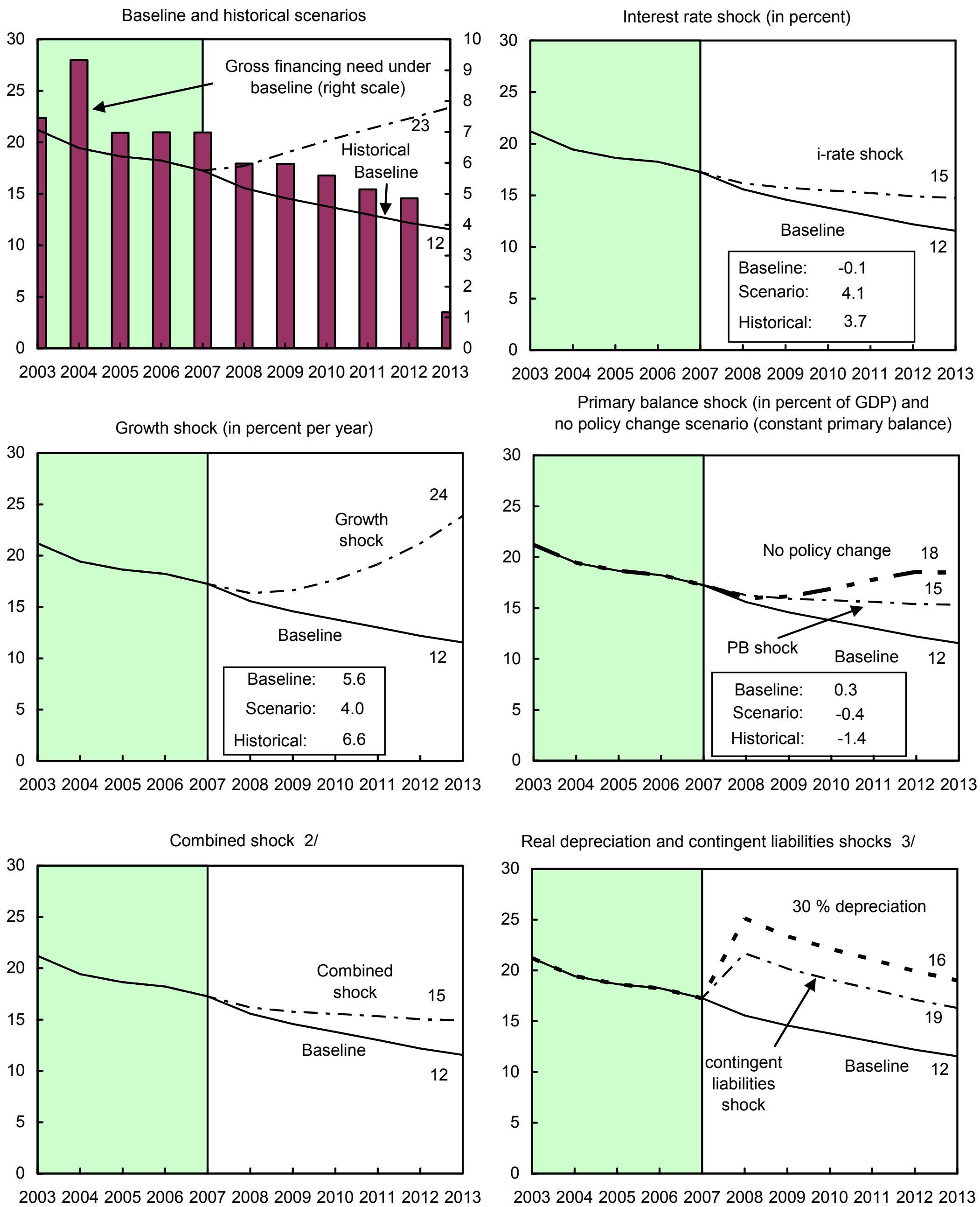
Source: IMF staff estimates.
1/ General government gross debt.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = REAL GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The REAL interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the REAL growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include REAL GDP growth; REAL interest rate; and primary balance in percent of GDP. 9-year historical averages due to lack of consistent general government debt data for 1995-97.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (REAL GDP growth, REAL interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 1. Lithuania: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2008.

Figure 2. Lithuania: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: Lithuanian authorities; and IMF staff estimates.
1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Statement by the Staff Representative on the Republic of Lithuania
April 16, 2008

1. This statement reports on key data releases since the staff report was issued. The new information does not alter the thrust of the staff appraisal.

2. **The balance of payments in 2007 was broadly in line with the estimates in the staff report.** The somewhat larger-than-estimated current account deficit was more than offset by much smaller-than-estimated errors and omissions, resulting in smaller-than-estimated financial flows.

Lithuania: Balance of Payments, 2007
(In percent of GDP)

	Estimate	Actual
Current account	-13.0	-13.7
Capital account	1.6	1.8
Financial account	16.7	15.7
Errors and omissions	-1.8	-0.6
Reserve buildup	-3.2	-3.2

3. **Private sector credit growth continued to slow to 42½ percent year-on-year in February.** The slowdown was most pronounced for household lending, both mortgage- and consumer-related.

4. **CPI inflation edged up to 11¼ percent year-on-year in March.** The rise was due to increases in food price inflation and core inflation, especially of nontradables, as well as an increase in the excise tax on tobacco.

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IMF Concludes 2008 Article IV Consultation with the Republic of Lithuania

On April 16, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Lithuania.[1]

Background

Economic performance over much of the past decade has been very strong, reflecting in part broad macroeconomic stability. The growth rate of real GDP per capita has been one of the highest among emerging market countries, inflation one of the lowest, and the unemployment rate has declined. These favorable developments have been supported by EU accession, rapid financial integration, and generally sound macroeconomic policies, including the currency board arrangement, the low and declining level of public debt, and relatively flexible labor and product markets.

However, external and internal imbalances increased in 2007. The external current account deficit widened to an estimated 13 percent of GDP and end-year Consumer Price Index (CPI) inflation rose to 8¼ percent. House prices continued to increase, accompanied by a rising share of property-related investment in GDP and rapid credit growth. Rapid wage growth led to an appreciation of the real effective exchange rate.

Public finances are generally sound, but fiscal policy turned procyclical in 2007. General government debt fell from 24 percent of GDP to 18 percent of GDP between 2000–06, reflecting small fiscal deficits and rapid GDP growth. However, in 2007, the fiscal deficit (including

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

restitution payments) widened to 2 percent of GDP, giving rise to a fiscal stimulus of ½ percent of GDP. A fiscal responsibility law was enacted in November 2007. The law prohibits mid-year budgets, requires that revenue over performance be saved, and stipulates that the government budget aim for balance or better, subject to escape clauses intended to avoid procyclical policy in an economic downturn.

Indicators of the banking system's soundness are generally satisfactory. Profitability is high and nonperforming loans are low, and capital adequacy has increased in recent years. Foreign-owned banks account for about 85 percent of the banking system's assets. In recent years, the Bank of Lithuania (BOL) has strengthened banks' capital bases by raising the effective risk weight on residential mortgages, restricting the amount of current-year profits that count toward regulatory capital, and asking banks to fully retain profits. The BOL has also urged banks to pay due attention to loan-to-value ratios and debt-service-to-income-ratios, and to conduct stress tests on borrowers' debt service capabilities under different interest rate scenarios. In the non-bank financial sector, assets have grown rapidly and financial institutions are becoming increasingly sophisticated.

Executive Board Assessment

Executive Directors commended Lithuania's impressive economic performance over much of the past decade—in particular, rapid economic growth and rising employment rates—that reflected EU accession, rapid financial integration, and generally sound macroeconomic policies under the currency board arrangement.

However, Directors raised concerns about the recent rise in external and internal imbalances, characterized by an unsustainable current account deficit and an increase in domestic inflationary pressures, resulting from excess domestic demand. Directors observed that these imbalances will need to be reduced significantly over the medium term in order to contain external vulnerabilities. They also noted that, although the level of the real effective exchange rate is still broadly appropriate, continued rapid wage growth could erode competitiveness. Given the currency board arrangement, Directors stressed that fiscal and structural policies hold the key to stabilization and growth.

Looking ahead, Directors considered that tightening financing conditions would lead to an orderly easing of imbalances in 2008–09, and concurred that a soft landing of the economy is the most likely scenario. Given tighter bank lending standards and the cooling of the housing market, a substantial slowdown in credit growth is likely. Therefore, while the economy's underlying momentum remains strong, Directors expected domestic demand growth to slow, leading to a narrowing of the current account deficit and an easing of inflationary pressures. However, Directors were concerned about the risk of a hard landing. They cited the experience of other countries where rapid house price increases were sometimes followed by abrupt house price declines. Directors cautioned that Lithuania's reliance on external financing makes it vulnerable to a sharper scaling back of new lending by parent banks. If these risks materialize, domestic demand growth could slow quickly.

Directors welcomed the planned tightening of fiscal policy in 2008, and suggested additional fiscal contraction to support a soft landing. They recommended that the government start preparing for further fiscal consolidation in 2009, with the goal of achieving cyclically-adjusted balance by 2010. Directors urged the government to resist pressures to cut taxes, introduce new exemptions or tax credits, or raise spending in the run up to the October 2008 elections. They welcomed the new fiscal responsibility law, and supported the government's plans to further enhance transparency and reduce the risk of procyclicality in an economic upturn. They also encouraged the authorities to give priority to increasing government efficiency within the context of a medium term fiscal strategy.

Directors emphasized that the priorities for bank supervision are to maintain high lending standards and strong risk management and to increase capital buffers. They welcomed the findings of the Financial Sector Assessment Program (FSAP) update, namely that indicators of the banking system's soundness are generally satisfactory and are expected to remain so under the soft landing scenario. Directors observed that the regulatory and supervisory framework for banks is in line with international standards, and that the Bank of Lithuania conducts effective supervision of all banks operating in Lithuania. They welcomed the Bank of Lithuania's measures in recent years to strengthen banks' capital bases and encourage strong risk management. Directors noted that the dominance of reputable foreign banks supports the banking system's resilience but also exposes Lithuania to the risk of financial contagion. Nevertheless, given the potential impact of low-probability extreme events on the banking system, Directors recommended that banks' capital buffers be raised and that contingency plans, including credit lines, in the event of liquidity shocks be further discussed with banks, parent banks, and home country authorities. As regards the non-bank financial sector, Directors urged the authorities to improve supervision given the rapid growth of assets and the increasing sophistication of financial institutions.

Directors observed that greater economic flexibility and productivity-enhancing reforms would support a soft landing by easing supply bottlenecks and would facilitate the reallocation of resources in the event of a hard landing. Priorities include easing restrictions on working hours, removing obstacles to immigration, improving the education system and encouraging investment in science and technology, and streamlining the assessment of firms' compliance with regulatory standards.

Republic of Lithuania: Selected Economic Indicators

	2003	2004	2005	2006	2007
Real Economy	(In percent)				
Real GDP growth	10.3	7.3	7.9	7.7	8.8
CPI inflation (end of period)	-1.3	2.8	3.0	4.5	8.2
Unemployment rate (end of year)	12.4	11.4	8.3	5.6	4.4
Public Finance	(In percent of GDP)				
General government overall balance	-1.4	-2.7	-1.3	-1.5	-1.9
Total general government debt	21.2	19.4	18.6	18.2	17.3
Public and publicly guaranteed external general government debt	15.0	13.9	11.2	13.4	12.3
Money and Credit	(Year-on-year percent change)				
Reserve money	26.6	7.1	27.6	19.3	21.1
Broad money	19.4	21.4	31.9	21.5	22.1
Private sector credit	56.6	40.3	56.1	51.4	45.3
Balance of Payments	(In percent of GDP; unless otherwise specified)				
Trade balance	-9.2	-10.6	-11.3	-14.1	-12.5
Current account balance	-6.9	-7.7	-7.1	-10.8	-13.7
Gross international reserves (in millions of U.S. dollars)	2,413	3,594	3,816	5,773	7,721
Exchange Rates	(Litai per U.S. dollar)				
Exchange rate (period average)	3.7	2.8	2.8	2.8	2.5
Exchange rate (end of period)	2.8	2.5	2.9	2.6	2.4

Sources: Lithuanian authorities; and IMF staff estimates.

Statement by Jens Henriksson, Executive Director for the Republic of Lithuania and Darius Abazorius, Senior Advisor to Executive Director
April 16, 2008

The Lithuanian authorities were pleased by the outstanding and professional cooperation with Mr. Morsink, Ms. Khamis and their teams. The authorities also welcome staff's appraisal of the recent economic developments and the policy advice on macroeconomic and financial policy. They broadly agree with staff's views and recommendations.

The authorities remain committed to taking further measures to maintain high quality of bank asset and strengthen capital buffers in the banking system. To limit demand stimulus and inflationary pressures, the authorities are seeking to tighten fiscal policy this year and to achieve a budget surplus next year. The authorities expect a soft landing, where imbalances contract gradually. However, the authorities are aware of the need to be prepared for a low-probability risk of a hard landing scenario.

The solid export performance and profitability of export companies support the view that the current account deficit is not related to the problems of competitiveness. Therefore, the authorities agree with staff that the real effective exchange rate is broadly in line with fundamentals. The authorities remain strongly committed to maintaining the current currency board arrangement.

Economic developments

1. Economic growth continued to be robust in 2007. Real GDP increased by 8 percent, marking the sixth consecutive year of rapid economic convergence. In 2008-2009, the GDP growth is expected to get closer to its potential.

2. The average annual inflation in 2007 was 6.3 percent. In 2008, the average annual inflation is forecasted to reach 7.9 percent, even though the 12-month inflation rate increased to 10 percent in January 2008 partly due to administrative decisions, such as tax hikes on fuel, cigarettes and alcohol. Higher food prices would contribute to half of the average annual inflation in 2008. The inflation is expected to slow down to 4.9 percent in 2009.

3. Although the current account deficit was projected to remain at 14 percent of the GDP in 2008-2009, the current account deficit decreased to12 percent in the last quarter of 2007. The projected recovery of the capacity in the oil refining sector will further contribute to export growth. Import developments will be reflecting a slowdown in investment and oil import. The growth rate of the gross fixed capital formation is projected to decrease from 16 percent in 2007 to 8 percent in 2008-2009.

4. Although the timing and the extent of the slowdown are still uncertain, the economy is cooling down. In the last quarter of 2007 and in the beginning of 2008, mortgage lending

slowed down due to tightened lending standards. But, at least so far, there was no significant price correction in the real estate sector or decline in the construction activity. The slowdown is expected to be driven by a decrease in domestic demand because of a declining credit flow and resource constraints on the labor market.

5. The authorities consider a soft landing as the main scenario due to robust profitability in all the main sectors of the economy. In the medium-term, a decrease in the household sector consumption would encourage a flow of financial and labor resources to more productive tradable sectors, which would help to ensure a more balanced growth in the future. While an abrupt decline in house prices could lead to a hard landing, the probability of such a scenario remains very low.

6. The authorities agree with staff that the underlying current account deficit of around 8 percent is in equilibrium and that the real value of litas is close to the equilibrium real exchange rate. The main indicators of export competitiveness – export market shares, export growth – did not show any signals of deteriorating competitiveness in 2007. Along with the strong growth in the exports of wood, furniture and food, there was a buoyant increase in the exports of chemical and plastic products and transport equipment, as exporters managed to take advantage of the favorable developments in external markets.

7. The high wage growth could become a great concern, but so far the accumulated productivity growth over the last 8 years is approximately equal to the accumulated wage growth. The authorities are aware that labor market convergence with the rest of the European Union creates challenges in limiting wage growth and that higher productivity is the way forward to contain competitiveness. The authorities are implementing structural reforms to improve the education system as well as encouraging investment in science and technology and important infrastructure projects.

Fiscal policy

8. The authorities agree with the mission's conclusions that further fiscal consolidation is needed to reduce demand pressures and increase fiscal cushions. The authorities are targeting a deficit of 0.5 percent and a surplus of 0.2 percent of GDP in 2008 and 2009 respectively. Excise duties on cigarettes and fuels were increased in 2008, and further increases are envisaged due to commitments assumed under the EU Accession Treaty. The authorities could consider to increase excise duties further in 2008, if the revenue performance is below the target. The abolishment of some tax exemptions could improve the revenue performance in the medium-term. A detailed impact assessment in the field of major tax exemptions is envisaged this year, with the first results in the second half of 2008. The mortgage interest deductibility is also currently under review.

9. The main Parliamentary Parties Factions have signed an agreement to balance the general government budget by 2009. In 2007, the authorities introduced fiscal discipline rules. The Law on Fiscal Discipline was adopted in November 2007 and the Guidelines on the Improvement of Fiscal Discipline System were approved in the 2007 Convergence Program. The Law on Fiscal Discipline not only ensures a better alignment of planned expenditures with revenues, but requires the authorities to take into account the conclusions of the ECOFIN Council.

10. The authorities are determined to continue with further efforts to improve public finance management. They have foreseen to provide stricter regulation on the borrowing or guarantees concerning loans used to finance state investment. The authorities noted staff's proposal to have independent scrutiny of the economy's cyclical position and some key revenue assumptions. Although the State Audit Office performs the audit of the draft budget, the authorities are committed to further strengthen the scrutiny of the budget. Key parameters for macroeconomic indicators and budget revenue planning should be based on the medium-term structural deficits of the general government calculated on the basis of the data by the European Commission.

Financial markets

11. The authorities are aware that the increased tension in the global financial markets requires vigilance and further strengthening of the banks' capital base, even if the banks are capable of withstanding potential difficulties and the level of their capitalization is basically the same as that of the EU banks. So far, the Lithuanian banks have remained relatively unaffected, with the exception of a slight increase in the borrowing costs, which may lead to lower profits in the future.

12. In recent years, the Bank of Lithuania (BoL) has been constantly acting to ensure a measured pace of credit growth and strong bank asset quality. As a result, domestic banks have granted loans more cautiously; also, they have tightened the loan granting requirements and decreased financing to the real estate projects. In the absence of a detailed development plan for a land lot, banks ask for additional collateral and higher pay-ins for loans for agricultural land purchase. Loan conditions by large domestic banks are expected to be tightened further in order to mitigate risks.

13. The authorities agree with staff that the external risk has increased, but it is manageable. As staff precisely pointed out, most of the external borrowing is from parent banks to finance credit growth, and the share of liabilities to parent banks is rising.

14. At the end of 2007, parent bank funding constituted about 68 percent of the external financing of the banking system. In 2007, an average remaining maturity of funding through direct parent banks increased to 40 months (from 28 months in the beginning of the year), while the share of liabilities coming due within a year fell by 27 percentage points to 21

percent. The financing from other foreign banks and financial institutions accounts for about 15-20 percent of the external financing and less than 10 percent of the banking system assets and represents limited risks in this respect.

15. Moreover, a slower growth in credit would limit further growth of external liabilities in the future. A close cooperation among the supervisory authorities and central banks of home and host countries helps to achieve a more effective response to counteract the potential tensions in the banking system, and ensure long-term interest and commitments of foreign banks in the Baltic markets. In the beginning of this year, a meeting took place between representatives of central banks and supervisory authorities of Sweden and the Baltic countries to discuss issues related to liquidity risk management and crisis prevention.

16. The implementation of the New Capital Accord (Basel II) continues to be one of the major tasks of the BoL. In 2008, banks introduced a new procedure for calculating capital adequacy. The BoL's Board approved the General Provisions for the Internal Capital Credibility Assessment Process aimed at risk assessment (in particular, credit risk) and the strengthening and improvement of risk management. Also, the General Provisions for the Supervisory Inspection and Assessment Process were approved. When implementing the Basel II requirements, each bank will be subject to the ICAAP assessment and, in case of any shortcomings, an additional capital adequacy requirement may be imposed on banks. In addition, the BoL considers further strengthening of the liquidity risk management as one of the main priorities in the area of supervision of credit institutions.

17. To ensure business continuity in banks and preparedness of banks for potential shocks, a new General Provision on Stress Testing was approved last year. The results of the testing done in accordance with the new requirements were submitted by banks to the BoL in the first quarter of this year. In implementing the Basel II requirements, new requirements were set for information disclosure. Banks will be obliged to publish significant information about their operational results, the management of assumed risks and other information necessary for consumers. In its own turn, the BoL takes part in the disclosure of the supervisory process; the information to be disclosed can be found on the bank's website.

18. The recommended implementation plan has been worked out, taking into account the recommendations received during the Financial Sector Assessment Programme. Furthermore, in order to strengthen management of both traditional and other risks, a draft General Provisions on Risk Management has been prepared. Individual meetings of the BoL's Board and heads of domestic commercial banks to discuss relevant issues are held on a regular basis.

19. To ensure that the supervisory and regulatory capacities are in line with financial system developments, the authorities agree with staff's advice to strengthen the regulatory and supervisory framework of the non-bank financial sector.