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UNITED STATES SEED ACT ASSISTANCE STRATEGY

FOR LITHUANIA



1993-1995

Submitted by American Embassy Vilnius

Approved, July 22, 1993

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UNITED STATES SEED ACT

ASSISTANCE STRATEGY

for

LITHUANIA

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STRATEGY
UNITED STATES ASSISTANCE STRATEGY FOR LITHUANIA
1993-1995

OVERVIEW

The United States is committed to helping Lithuania help itself through the difficult economic and political reforms now underway. The U.S. supports Lithuanian efforts to move to an economy characterized by market forces and private ownership, and a political environment based on democratic institutions and processes.

The United States Government (U.S.G.) assistance program is a modest one in a relatively small country. Nevertheless, the U.S. plays a leadership role among the bilateral donors due to Lithuania's close ties to the U.S. through the extensive community of Americans of Lithuanian heritage who support government and private assistance. With the presence of multilateral and several European bilateral donors, the keys to success are coordination and a well focused program.

Lithuania and its Baltic neighbors look to the West as their future, but are still tied to their past as parts of the former Soviet Union. The Lithuanian people, their structures, and systems were totally absorbed into the Soviet Union and completely dominated by Moscow for 45 years. The result is a mind set that has been unaware of Western economics, private property ownership, and most of the basic private enterprise attitudes taken for granted in the West and visible in other parts of Eastern Europe.

Given our limited resources, the activities of other donors, the pressing needs for immediate assistance, and the priorities of the Government of Lithuania (GOL), this strategy emphasizes the most urgent needs as identified in consultation with the GOL and the comparative advantages offered by U.S.G. types and modes of assistance. Regional approaches, particularly but not exclusively in the areas of energy and environment, should be pursued. The strategy concentrates on three urgent priorities: (1) the need to develop the private sector, with emphasis on financial sector reform and business sector promotion; (2) addressing the need for energy efficiency and the safety of the Ignalina Nuclear Power Plant; and (3) strengthening democratic institutions, both governmental and non-governmental.

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The current economic climate in Lithuania is clouded with uncertainty. Leadership changes resulting from recent elections for the parliament and presidency have left many investors and donors uncertain about the new GOL's commitment to continuing a rapid pace of economic restructuring. Signals from the new GOL indicate that it intends to proceed with stabilization measures in accordance with IMF conditions and foster an environment conducive to greater external and domestic confidence and investment. Since the new government has been in place for only a few months, this appraisal will be carefully monitored throughout the three year period covered by this strategy document.

OBJECTIVES OF THE GOVERNMENT OF LITHUANIA

The new Government of Lithuania has identified a program of economic reform based on market principles. It has announced that its main goal is to stabilize the domestic economy. It seeks to halt the continuing decline in production of goods and services (real GNP from 1990 through 1992 dropped in real terms by 49 percent) and to reduce inflation. Inflation has soared in the last year and between 50 and 70 percent of the average family income is spent on food.

In pursuing these economic goals the GOL has acknowledged its intent to comply with the macroeconomic policy memorandum of 1992 which is the agreed basis for IMF support to the country. Economic reform is to be concentrated in:

- Development of a competitive market economy through further privatization, liberalization and export promotion;
- Development of a pro-market policy infrastructure, including the further decontrol of prices, early introduction of the Litas, adoption of tight monetary policy, and a fiscal policy aimed to encourage economic production. Inflation is to be fought among other means by removing restrictions on the use of money (in lieu of investment vouchers) in buying shares of companies being privatized. There is to be free movement of labor and capital; and
- Development of a social safety net. An adequate minimum wage is to be the central feature of welfare legislation. Other transfer payments are to be limited.

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These objectives will not be achieved as the result of the U.S.G. assistance program alone. Their attainment will be realized only by the sustained efforts of the Lithuanian people with the donor community playing a supporting and coordinating role.

ROLE OF MAJOR DONORS AND LENDERS

As part of its Stand-By Agreement, the IMF has granted \$86 million to the Government of Lithuania to provide general support to the GOL's economic program, so long as Lithuania adheres to its IMF economic policies memorandum. The World Bank has granted the GOL an import rehabilitation loan in the amount of \$60 million. The loan will finance essential imports in the health, agriculture and energy fields, as well as finance production inputs by individual enterprises imported through normal commercial channels.

The EBRD has granted an ECU 35.7 million emergency energy sector loan directed at assisting in securing adequate short-term energy supplies and in promoting sector structural reform, environmental management, and energy conservation and efficiency. In the communications sector, EBRD is financing the Eurovision Network Expansion Project which will link Lithuania with the European Broadcasting Union, and is assisting in the development of a master telecommunications plan and regulatory framework.

The EC recently established an Aid Coordination Unit based at the Ministry of Foreign Affairs as a first step in coordinating donor assistance. The EC plans to assist in stimulating agricultural production, privatization, management, education and land reform initiatives. The EC has ECU 4 million reserved for large-scale enterprise restructuring, including the diesel engine industry. It eventually intends to open three regional small and medium sized business advisory centers, and is establishing an ECU 3 million credit line for employers with less than 200 employees. The EC is providing technical assistance supporting the EBRD and World Bank energy loans, and plans to do a safety assessment study of the Ignalina nuclear power plant. The EC is currently setting up a framework for public administration assistance.

Denmark is providing technical assistance to modernize agricultural education and production, and to harmonize agricultural and environmental concerns. Denmark is further involved in the environment sector in the areas of water pollution and waste management and disposal. It is assisting the oil and gas industries with privatization and

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management development, and is developing a machine condition monitoring and maintenance system for Ignalina. Denmark's largest activity is an investment of \$35 million in installing a pilot telecommunications network in Kaunas, which is based on digital systems and fiber optics, and will provide direct access to international calls. This effort complements the installation last year of a telephone switching system by U.S. West.

Sweden provides its greatest assistance in the nuclear energy and safety sector. The Swedish Nuclear Power Directorate is providing institutional support in developing a legal framework for nuclear power and radiation protection and is assisting in the development and education of the Lithuanian Nuclear Safety Authority as well as providing support to improve operational safety at Ignalina. Non-nuclear sector assistance includes assistance with agricultural pollution and other environmental efforts.

Germany has agreed to commit DM 3 million for the design, construction and institutional development of a Lithuanian vocational center. It intends to provide technical assistance to the Lithuanian Investment Bank, and just signed an agreement with the Ministry of Justice to provide assistance in the commercial law area. Germany is assisting the transport sector by conducting a feasibility study for the development of the Lithuanian railway system and training Lithuanians in this sector.

An unfortunate result of the recent change of Lithuania's government was the abolition of the Ministry of International Economic Relations (MIER), which was responsible for all donor coordination activities. The result is that effective donor coordination has suffered. The GOL has announced that technical assistance is now to be coordinated by the Department of Economics within the Ministry of Foreign Affairs (MFA), with other ministries becoming involved in other types of assistance. The new EC Aid Coordination Unit is an important step in reestablishing this vital function within the GOL.

CONTRIBUTION OF THE U.S.G. ASSISTANCE PROGRAM

The goal of the U.S.G. assistance program is to help Lithuania achieve the objectives outlined above, although current resource levels provided by the U.S. on a bilateral basis are clearly dwarfed by the magnitude of the task. At best, we can guarantee that the assistance program that we operate is well coordinated with other donors and highly focused in areas where we have a comparative advantage. In general,

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technical assistance should be medium and longer term in nature rather than the relatively more expensive and frequently less effective short term assistance. The U.S.G. assistance program has concentrated on flexible delivery mechanisms that respond rapidly to new and unanticipated demands in a few, well chosen areas. The effectiveness and impact of our program depends on continuing with this approach and improving coordination among other donors as well as among U.S.G. agencies receiving SEED funds.

The U.S.G. has, therefore, worked closely with the GOL to identify priority areas where we have the clearest comparative advantage over other donors: private sector development, energy sector reform, and democratic initiatives. Development of the private sector depends critically on reform taking place in the financial sector, the business sector (including privatization and commercial law development), environmental protection, and the agricultural sector. The issue of energy sector reform involves instituting rational pricing mechanisms, improving energy efficiency, and improving nuclear safety of the Chernobyl-style reactors at Ignalina. The U.S.G. considers as one of its foremost goals the continuation of democratically elected government and the processes that accompany it. Likewise, the GOL stresses the importance of support for nascent democratic institutions as they develop in the coming years. The U.S.G. has made the decision not to become heavily involved in assistance in the social sectors of health and education in order to limit the number of sectors it becomes involved in and because the GOL has not yet made crucial decisions regarding the direction such reforms in these areas would take. Many private organizations are providing such assistance, particularly in the health sector. In addition, the United States Information Service (USIS) and the Peace Corps have some programs in education and training.

Although a significantly higher level of resources could be utilized, this strategy assumes that the current level of assistance to Lithuania approximately \$10 million annually in SEED funds, will be maintained in FY 1994, possibly with a slight increase over the next couple of years. When the Baltic Enterprise Fund begins operations, it will result initially in a net increase in total funding. It is difficult at this time to address the issue of a program phase-down. Unlike its Baltic neighbors, Lithuania has been unable to stabilize its economy. This has been due both to structural weaknesses in the state owned enterprises and the financial sector, as well as uncertainty in economic policy due to changes in government. As a result, inflation has frequently been more than 10 percent a month, interest rates remain highly negative, and the use of hard currencies in transactions is common as the local currency has generally depreciated against the dollar. Therefore, until the dust settles and we can get a clear picture of the length of time

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economic recovery might take, it will remain difficult to make predictions about termination of the program.

PRIORITIES OF THE U.S.G. ASSISTANCE PROGRAM

I. PRIVATE SECTOR DEVELOPMENT

Experience from other parts of Eastern Europe indicate that, because the enterprise and financial sectors are closely intertwined, the necessary restructuring of the banking system should take place in tandem with the restructuring of the business sector. Economy-wide productivity will be enhanced by the development of legal and regulatory reforms protecting the environment, as well as by development of a private agricultural sector that promotes the most efficient allocation of scarce resources.

A. Financial Sector Reform

There is an urgent need in Lithuania to devise a coherent strategy for reshaping the banking system so that it can more efficiently perform the intermediation services -- mobilizing deposits and on-lending them to final borrowers -- required by a market economy. The majority of individuals continue to place their savings with the State Savings Bank despite strongly negative real interest rates. In fact, two-thirds of all bank assets are controlled by the three State banks (including the State Commercial Bank and State Agricultural Bank), with the remaining one third divided among 23 commercial banks.

Although direct state bank lending to public sector enterprises has been reduced, arrears among state-owned enterprises have become, de facto, an informal means of financing of the economy which may erode the effectiveness of credit control by the monetary authorities. This problem has the potential to undermine the success of the country's economic transformation. A thorough financial and operational audit of each bank is needed to determine the degree to which non-performing loans are undermining their solvency and the consequent scope for their restructuring, privatization or liquidation.

Although there appears to be a relatively well developed interbank market for deposits in Lithuania, there is still room for improvement of the payments systems.

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Almost all transactions are carried out in cash, which puts a heavy burden on bank personnel and clients and is a drag on overall system efficiency. Payment delays of several weeks are still not uncommon although such delays since May 1993 are mostly due to credit problems in enterprises and have become less severe.

Despite substantial liquidity in the Lithuanian banking sector, for several reasons, loans are not being made. Lack of a law on secured (collateral based) lending is a major impediment to lending, particularly long term. The implementation of bankruptcy laws would enforce borrower discipline and establish the rights of banks when loans are not paid. A lack of skills and procedures among banks and bankers for credit analysis, as well as lack of credit reference systems, slows loan making. A thorough understanding of the financial sector will take place only when banks are required to prepare their accounts and have them audited on the basis of international accounting principles. Much work needs to be done to put in place modern accounting systems and to ensure that an indigenous, well trained auditing capacity is developed. To do this it will be necessary to develop training opportunities for the banking sector so that they can acquire these skills. In addition, the development of the banking system will enable the creation of a functioning domestic housing mortgage market.

U.S. Assistance to the Financial Sector Will:

- strengthen the ability of the Central Bank to supervise and regulate commercial banks, carry-out prudent monetary policy, and facilitate international transactions;
- facilitate the development of government debt instruments, tax laws and other legal requirements necessary to strengthen the Lithuanian financial sector;
- provide commercial banks with technical skills in bank management, credit analysis, international operations, accounting standards, and supervision; and
- speed the development of an improved payments system.

B. Business Sector Promotion

The U.S. has an important role in promoting the transformation of the Lithuanian business sector from one of state ownership and control to one based on private ownership. This role focuses on the development of an environment in which new private

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businesses can develop and grow, whether they originate from the privatization of existing enterprises or through the start-up of new ones.

The pace of privatization in Lithuania has been brisk. Foreign investors can now buy privatized companies, and the Lithuanians are experimenting with a variety of privatization models. As of December 1992, almost 90 percent of residential dwellings that were scheduled for privatization had been transferred to private hands, and nearly 80 percent of small enterprises had been privatized by auction by December 1992. 1,180 medium and large enterprises were privatized by public share subscription, including 350 industrial enterprises. Newly-created small private firms (about 70,000 have been registered) are steadily expanding the range of products and services to Lithuanian consumers.

Although privatization is off to a good start, progress has slowed lately. There are difficulties in the "transaction" phase of selling a state industry and in reforming those state industries not sold so as to enable them to become more efficient and work toward becoming private entities. For the final category of state owned firms -- those that are destined for privatization through bankruptcy -- assistance is needed in understanding, implementing and enforcing bankruptcy legislation.

Legal and regulatory reform is critically needed in a number of areas for the development of a thriving business sector. The current environment in which businesses operate is an amalgamation of old rules and laws inconsistent with the principles of a market economy and a rapidly evolving series of new legal and regulatory requirements. Difficulties in company registration, and securing legal title to collateral pledged against a loan are only a few examples of poorly functioning systems which act as a drag on private sector development and growth. The lack of effective environmental legislation, regulation, and enforcement creates investment uncertainties and discourages environmental responsibility. Difficulties in the implementation of legislation providing for land restitution and agricultural privatization jeopardize development of one of the most important sectors of the Lithuanian economy.

A further impediment to the development of the private sector is the dearth of management talent at all sizes of enterprises. Lithuania has been completely isolated from western business influences and continues to rely on management trained in Soviet methods. Thus, businesses continue to be ill prepared to compete in a global environment. U.S. assistance in training and educating entrepreneurs will have a lasting impact on the Lithuanian economy.

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U.S. Assistance to the Business Sector Will:

- provide investment capital through the Baltic Enterprise Fund;
- strengthen enterprises in areas such as accounting, finance, marketing, production, and management;
- provide policy advice to the GOL on investment issues;
- strengthen the formulation and implementation of environmental legislation that affects businesses; and
- further privatization efforts of the GOL.

C. Environmental Protection

There is an urgent need in Lithuania to devise a coherent plan for protecting the environment while dealing concurrently with the transformation of the economy. Although trade-offs between economic development and environmental degradation are impossible to avoid in the short term, there remains considerable scope for coordination of reforms of basic economic institutions and reforms of environmental policy. Market based incentives (something as simple as energy price reforms) that ensure responsible use of the environment can also promote efficient private sector development. An important example is the use of more efficient techniques in agriculture: resource use and the quality of the environment improve when fertilizer subsidies are removed and land-ownership gives farmers an incentive to protect the long-term quality of the land.

Environmental protection efforts generally fall into one of three groups: 1) environmental clean-up, 2) environmental policy reform, 3) and the conservation and preservation of scarce natural resources, wildlife and habitat. The Lithuanian Environmental Protection Department has identified four priority areas for environmental policy action: surface water pollution, clean-up of hazardous wastes, nuclear safety, and air pollution.

The obvious differences in the monetary commitment required for environmental protection have resulted in a two tier environmental aid program. At one level is the World Bank, the EBRD, and the EC (and to some extent Sweden). These donors provide the bigger contributions necessary for large-scale investment projects and clean-

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up exercises. They also tend to be concerned with the "over-all" picture for the Lithuanian environment and economy.

At the second tier is bilateral government-to-government activity, of which the U.S.G. is one of the most active. These donors tend to provide ongoing technical assistance, in an attempt to fill the gaps left out by the large-scale, project-specific donations. These gaps tend to be largely informational, in the form of providing expertise and policy reform advice. Since many of the environmental issues and problems are common among the Baltic countries, common approaches and delivery mechanisms should be used.

U.S. Assistance in Environmental Protection Will:

- improve GOL understanding of environmental laws and regulations and how they affect the private sector;
- strengthen the ability of the GOL to develop and implement these laws;
- enhance knowledge of the interactions and trade-offs between economic development and environmental protection; and
- promote economic policy, waste minimization, and pollution prevention.

D. Agricultural Reform

To increase productivity, development of a private agricultural sector is critical to the future of the Lithuanian economy, yet issues exist in the determination of asset title and ownership, agribusiness development, technological development and marketing. U.S. assistance over the next few years should emphasize more deliberate support to commercially viable agri-businesses and agro-producers; and, depending upon the pace of domestic privatization, further U.S. assistance may be warranted in privatization of agricultural enterprises. Further evaluation and assessment of this sector is needed. Agricultural development is emerging as an even greater priority for the new GOL.

U.S. Assistance to the Agricultural Sector Will:

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- promote farmer bargaining and marketing associations, farm supply and service cooperatives as well as U.S. style farmer cooperatives that vertically integrate into processing and manufacturing;
- engage in policy dialogue to expand privatization programs and the creation of an agricultural credit fund using PL 480 local currency generations; and
- improve the commercial viability of agribusinesses.

II. ENERGY

The Lithuanian energy sector is characterized by almost total dependence on imported oil, gas, and nuclear fuel from Russia; inefficient use of energy in industries and buildings; old and inefficient thermal power and district heating plants; and a large Chernobyl-design RBMK nuclear reactor, which is considered unsafe by Western experts.

Shortages of fuel in 1992-93 resulted in cutbacks in heat to residential consumers and production curtailments in industry. Foreign exchange constraints severely limit the Lithuania's ability to import needed energy, invest in rehabilitation of plants, explore for oil and gas, and modernize the large Mazeikiai refinery. Both the EBRD and the World Bank have provided funding for emergency energy imports. The Government substantially increased energy prices in 1992 and is developing an energy policy and sector restructuring strategy. The creation of a clear policy and institutional restructuring framework is critical to mobilizing foreign loans and private investment.

At the request of the G-7 in 1992, the World Bank and the Lithuania government have prepared a study on scenarios and options for the Ignalina power complex. This plant is a major source of export revenues as well as providing over 80% of Lithuania's domestic requirements. The Government does not consider itself in the economic position to close the plant in the near-term since it has neither the funds to build alternative nuclear facilities nor to finance imported fuel or electricity. It is therefore looking to upgrade the safety of the plant and is looking to Swedish, EC, and U.S. assistance in this process.

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U.S. Assistance in Energy Will:

- increase the safety of the Ignalina nuclear power plant and develop an effective, independent nuclear regulatory authority;
- support improved energy efficiency in industries and buildings through price reform, electric utility demand side management programs, and demonstration projects that stimulate the development of local, private energy service companies;
- promote power sector restructuring and modernization through improving the management and financial viability of the electric companies, enhancing organizational effectiveness, upgrading technical efficiency, and developing a legal and regulatory framework that facilitates investment; and
- further regional cooperation among the Baltic countries through activities that facilitate electricity trade and pricing agreements improve and expand oil and gas trade and pipeline/storage system development, encourage regional planning on major investments in capacity expansion and interfuel substitution projects.

III. STRENGTHENING DEMOCRATIC INSTITUTIONS

Recent political developments in Lithuania demonstrate that ideals of democracy are tested in the face of harsh economic realities. Accordingly, assistance which addresses the two previous U.S.G. assistance priorities will help foster an environment in which fragile democratic institutions can strengthen their footholds in Lithuania.

The political and civic democratic process must be empowered; this can only be accomplished by empowering the Lithuanian people through education and by encouraging responsiveness and accountability in public officials. Necessarily, many of the GOL officials and civil servants are holdovers from a non-responsive and over-centralized communist system of government. Sustained efforts will be necessary to overcome the Soviet legacy, to encourage development of watchdog organizations and to develop public confidence in the system. Assistance should thus focus on promoting the political process, strengthening the foundations and institutions of a civil society, and public sector reform and development. Assistance will continue to involve ongoing and planned USIS activities in this area as well as A.I.D. grants to organizations specializing in democratic institutions.

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U.S. Assistance Will:

- Promote the development of an independent and well-trained judiciary, including court restructuring and the creation of a constitutional court;
- Assist the legal system in addressing issues involved in the rule of law in a free and democratic society, including constitutional issues, civil service, government ethics, and legal structures to deal with organized crime;
- Promote political party development and the improved functioning of the legislative body of government;
- Assist local PVOs and NGOs, including trade associations, to play an advocacy role for their constituents;
- Promote the role of an independent media in a free and democratic society;
- Promote and strengthen public administration (initially at levels below the central government) to promote the decentralization of authority, bolster local government capacities to plan and implement programs, and encourage development of public administration programs in institutions of higher learning; and
- Promote civic education programs which explain roles and responsibilities of groups and individual citizens in a democratic society.

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POLITICAL ANNEX

Lithuania declared its independence in 1990 after 45 years of Soviet occupation. The new Constitution, adopted by a popular referendum on October 25, 1992, provides for a popularly elected unicameral legislature, called the Seimas; a popularly elected President, who functions as Head of State with considerable powers in foreign and security affairs; and parliamentary democracy form of government led by a Prime Minister and other ministers, appointed by the President and approved by the Seimas. The government exercises authority with the approval of the Seimas and the President.

In parliamentary elections on October 25 and November 15, candidates from the Lithuanian Democratic Labor Party (LDDP), which in 1989 broke away from the Soviet Communist Party, won an absolute majority in the Seimas. The Seimas elected Algirdas Brazauskas, the LDDP chairman, as its Chairman and as Acting President until February 14, 1993, when Brazauskas was elected to the presidency by direct vote. Brazauskas then appointed Adolfas Slezevicius Prime Minister. The LDDP has assembled a broad-based government that includes some Sajudis (former GOL) members, and disclaims any communist ideology. Despite his communist party background, Brazauskas was a strong supporter of Lithuanian independence and advocates free market reforms and the expeditious withdrawal of Russian forces.

Lithuania's population is 80% ethnic Lithuanian, 9% Russian, and 7% Polish. Lithuania adopted a "zero-option" citizenship law on December 13, 1991, which extends citizenship to persons who were born in Lithuania; who were citizens prior to 1940, and to their descendants; and who became citizens prior to December 11, 1991. All applications for retention, restoration and naturalization go through a citizenship committee appointed by the Seimas, which appears to have wide discretion. Qualification for naturalization requires a ten-year residency, permanent job or source of income, knowledge of the constitution, and proficiency in Lithuanian. Over 90% of all Russians and Poles residing in Lithuania have been granted citizenship.

The Lithuanian and Russian Defense Ministers signed an agreement on September 8, 1992 which provides for a timetable and modalities for complete Russian troop withdrawals by August 31, 1993. The Russian troop presence is currently estimated

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at 10,000. Despite public statements by Russian leaders that put into question Moscow's resolve to withdraw its troops, withdrawals have continued as scheduled.¹

The three months between the parliamentary and presidential elections resulted in a period of political indecision. Since the presidential election, the transition has proceeded slowly with many sub-ministerial appointments yet to be made.

¹ Most of the last 2,500 Soviet troops were withdrawn on August 31, 1993; a few stragglers remain.

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ECONOMIC ANNEX

In 1992, Lithuania was plagued with serious energy shortages, a lack of capital -- primarily because of former Soviet republics' arrears to Lithuanian firms -- and a severe drought, all of which negatively affected the economy and complicated reform efforts. In 1992, real GDP declined 35 percent with real investment and household consumption particularly hard-hit. Industrial output is estimated to have fallen by over 50 percent compared to the previous year.

The Consumer Price Index (CPI) in local currency terms rose by 1,150 percent in 1992 (near 30 percent in December and 10 percent in January) while real wages fell by more than 50 percent between July 1992 and January 1993. Interest rates remained highly negative in real terms. Difficulties in reaching agreement with Russia on energy imports and the slow disbursement of foreign assistance resulted in a sharp compression in the volume of imports in 1992. Exports, constrained by the shortage of imported inputs, were much weaker than anticipated, although the share of exports going to the west increased to about 20 percent of the total.

Despite the end of regulations limiting labor-shedding by enterprises, the unemployment rate for 1992 was only 1.1 percent, although this is likely to worsen as more enterprises undergo restructuring. Underemployment is a significantly more serious problem in Lithuania, as enterprises rely on the use of unpaid leave and shorter working hours as a means to reduce labor use without formally laying off people. Prices on most foodstuffs and manufactured goods have already been freed from controls. Energy, housing, transportation, and communications are still, however, subject to price controls.

Although Lithuania met (and in some cases exceeded) all of the targets and performance criteria for the second tranche of its IMF Stand-by Arrangement, further reforms to improve fiscal performance are underway: the government hopes to improve tax administration and will levy a uniform 5 percent duty on imports with a few exemptions. Subsidies, currently at 2 percent of GDP are to be reduced to 1.4 percent of GDP. The banking system remains weak, and the financial situation of the state banks is marked by lack of liquidity. However, the banking system does function. It has responded to monetary policy and is steadily improving with capital increases, conservative lending policies, and operational improvements. An active interbank

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borrowing market has emerged which helps banking liquidity, the setting of interest rates, and faster responses to changes in the banking and business environment.

Although Lithuania established its own interim currency, the talonas, in the fall of 1992 to avoid many of the ravages of ruble inflation, there has been a sharp nominal depreciation of the talonas against the dollar of 38 percent from end-November 1992 to end-February 1993. Authorities attributed the depreciation mainly to the expansionary monetary consequences of ruble inflows from interstate correspondent accounts with the former Soviet republics that were then converted at par despite a 25 percent appreciation of the talonas against the ruble since the talonas was introduced. In May 1993, the talonas appreciated about 20% against the dollar as a result of stricter monetary policies involving reserve requirements. This is arguably the most important economic event of the past six months and may well be a turning point in financial sector reform. The permanent currency, the litas, was introduced on June 25, 1993.

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