

An Overview of Lithuanian Economy

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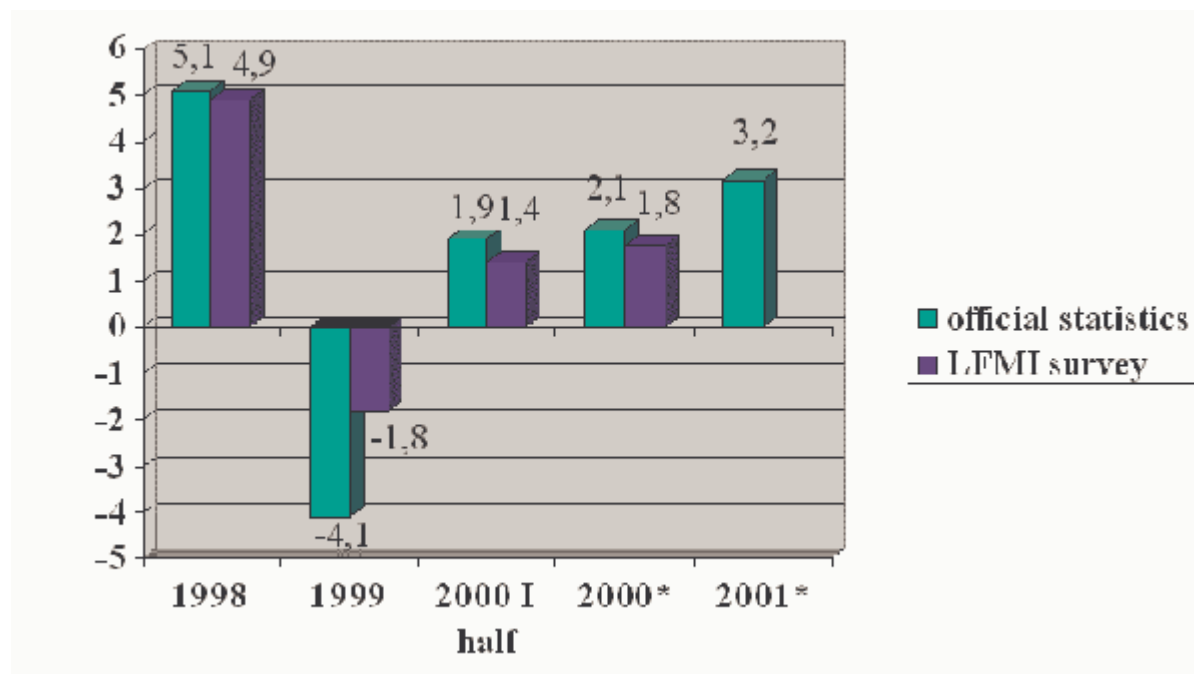
1. Macroeconomic situation in 2000: GDP growth, foreign trade, average salaries and household income, profit margin of enterprises.
2. Major reasons for economic stagnation: general business conditions, need for structural reforms (agriculture, social and medical care), privatisation, fiscal policy, liberalisation of business conditions.
3. Challenges of EU integration
4. Course of the new government and consequences for the economy

Lithuania has established solid foundations of a market economy. Significant progress has been made in macroeconomic stabilization, privatisation and liberalization of the economy. 70 percent of the country's GDP is produced in the private sector and nearly 70 percent of employed individuals work in the private sector. As stated in Regular report of the EU Commission, "Lithuania can be regarded as a functioning market economy," but it has to "continue the implementation of the current structural reform programme and undertake further necessary reforms."

So we have made considerable economic progress and we are moving in a right direction. Still, we should move quicker and, as the Lithuanian Free Market Institute (LFMI) sees it, the direction of this movement has to be straightened to the right.

1. Some data in numbers on the Lithuanian economy

GDP growth, %



* - forecast

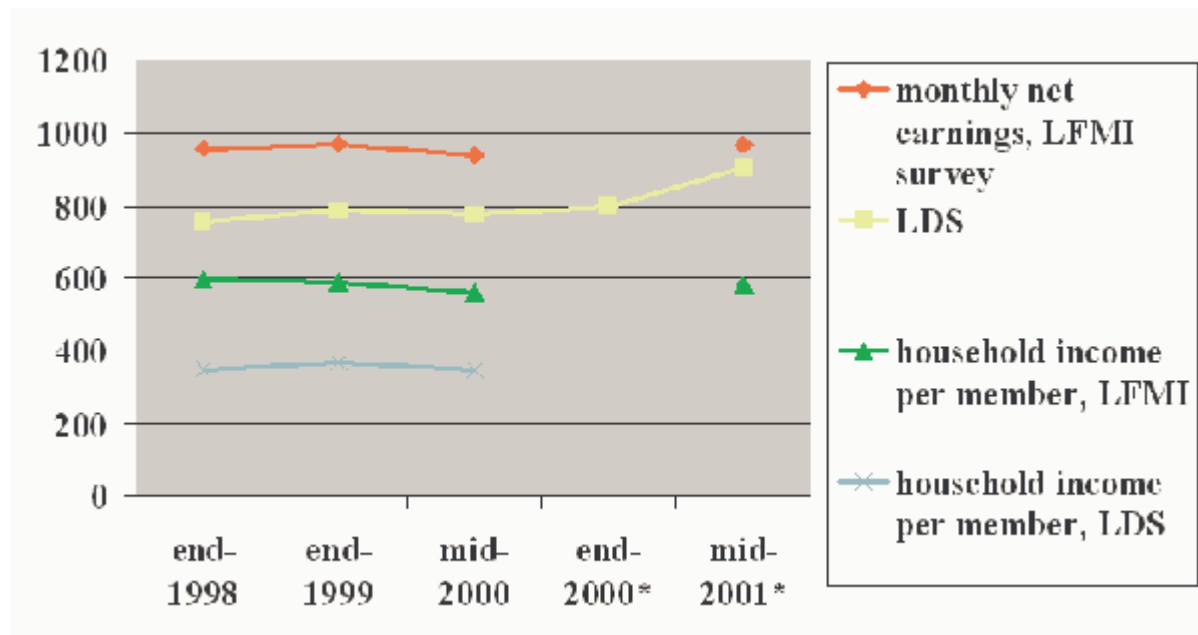
According to the preliminary data of the Lithuanian Department of Statistics (LDS), Lithuania's GDP grew by 1.9 percent in the first half of 2000. Just to remind, in 1999 GDP fell by 4.2 percent. The official

forecast states that GDP will grow by 2.1 percent this year. According to the survey of macroeconomic indicators held by LFMI, GDP grew by 1.4 percent in the first half of 2000, fell by 1.8 percent in 1999 and will grow by 1.8 percent in 2000. According to both estimates, the start of 2000 was a turning point from an economic decline to an economic upturn.

The major stimulus to economic growth during this period was export. Lithuanian enterprises managed to produce more competitive goods that were successfully sold in foreign countries, while recovering foreign markets, despite depreciation of the euro against the US dollar and the litas, improved these sales.

As the LDS reported, the volume of exports expanded by 25 percent in the first half of 2000 as compared with the corresponding period of 1999. It should be noted that the growth of export was largely affected by export of refined petroleum.

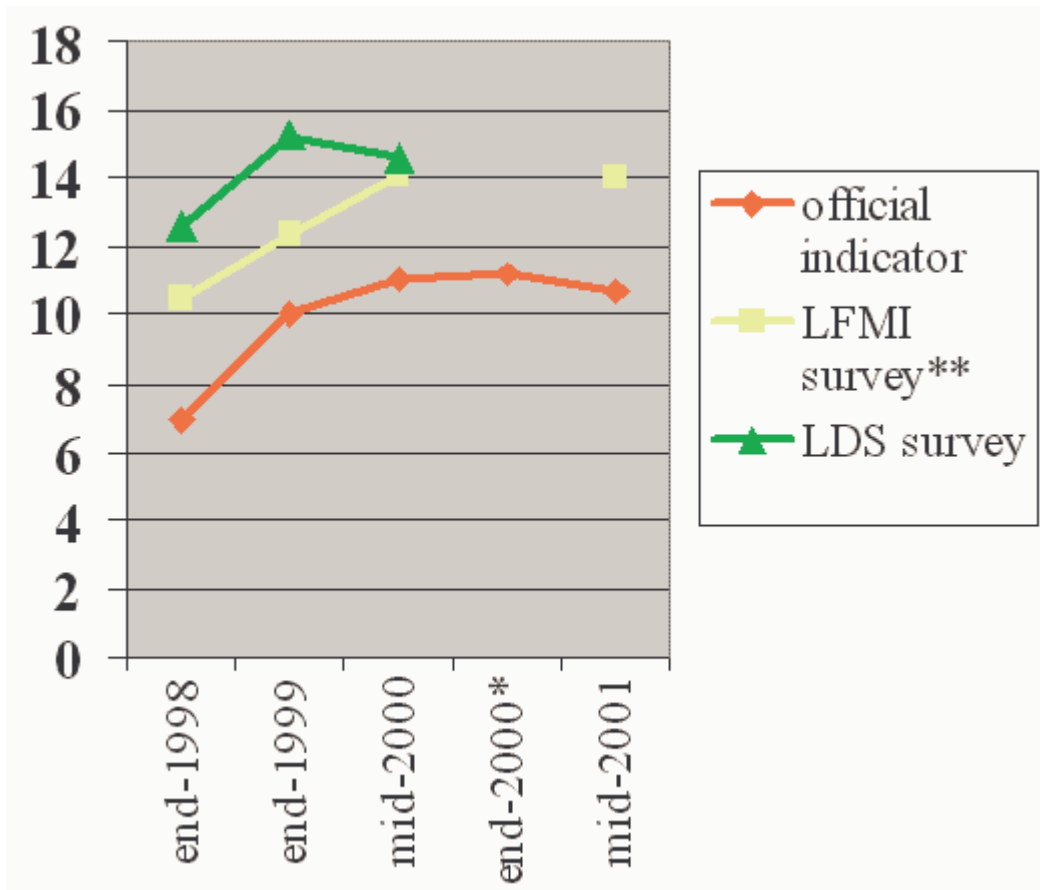
Average monthly net earnings and household income per member, litas



LFMI – Lithuanian Free Market institute/ Lietuvos laisvosios rinkos institutas
 LDS – Lithuanian department of statistics/ Lietuvos statistikos departamentas
 * - forecast

According to the LFMI respondents and official statistics, the level of unemployment continued to rise during this period, while household incomes shrank. The LFMI survey's experts think that since mid-1999 average personal earnings have been decreasing constantly but they forecast that average personal earnings will start to rise and in mid-2001 reach the level of late 1999.

Unemployment, %

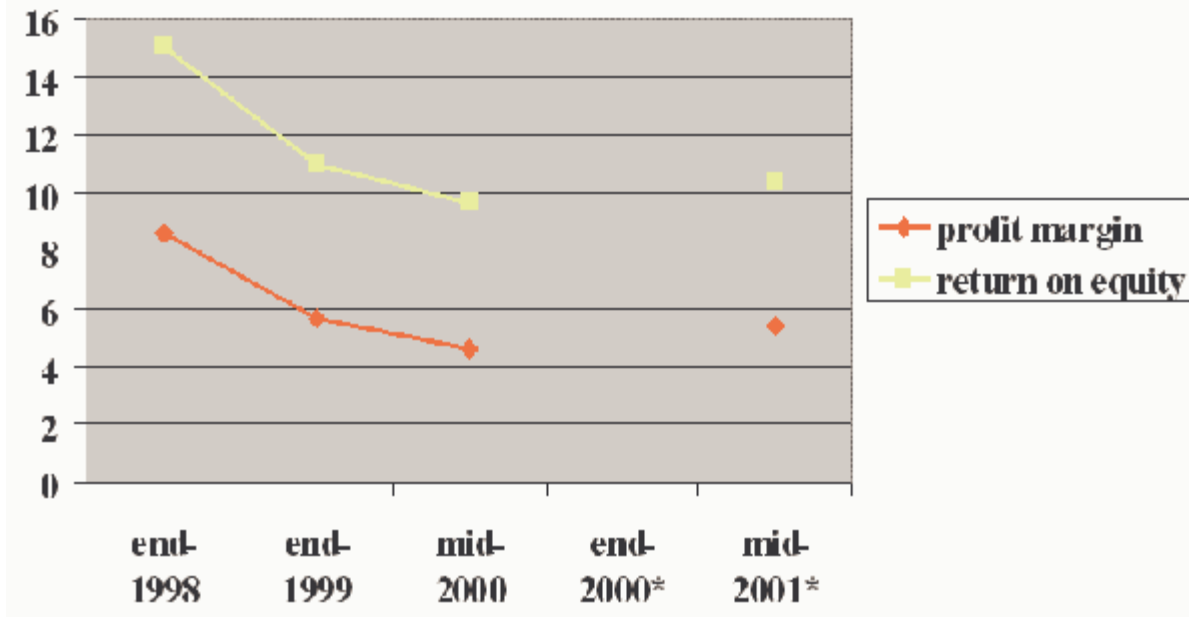


* Forecast

** excluding rural areas

The estimation of the level of unemployment in mid-2000 varies from 11 to 14.6 percent depending on the source and method of estimation. One way or other, it is quite high. The highest level of unemployment exists among unqualified labour force and in the regions where investments are made seldom. On the other hand, both in towns and cities, there is a lack of employees having specific qualification. The LFMI respondents forecast that the level of unemployment will remain stable in the coming year, while the Ministry of Economy projects that it will decrease. The Government declares ambitious plans to decrease unemployment markedly, though the means of achieving it are not explicit yet.

Corporate Indicators, %

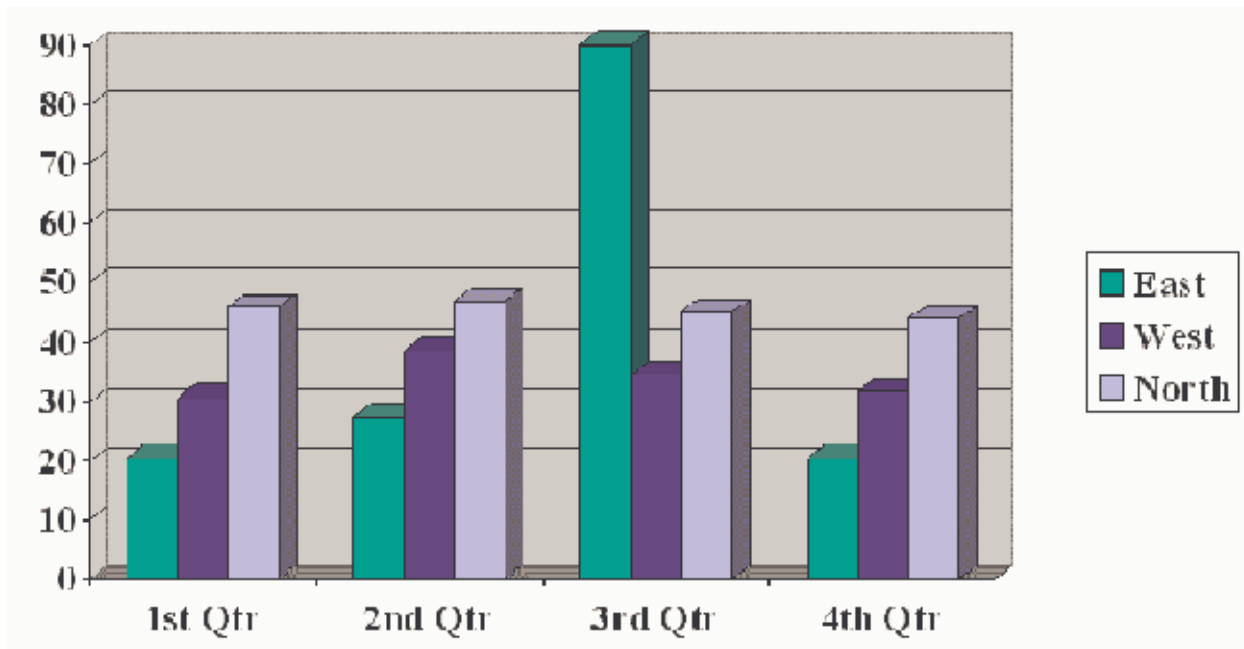


Source: LFMI survey

According to the expert estimates, profit margin and return on equity continued to decline in the first half of 2000, but a slight increase of these indicators is also expected. There is no doubt that competitiveness of Lithuanian enterprises has increased but many of them are operating on marginal income, therefore, they are reluctant to hire new people or to increase salaries.

2. Despite conspicuous achievements, we are lagging behind from Estonia and Latvia. Why? This question bothers many Lithuanians and not only because of their economic curiosity

Comparison



Economic problems in Lithuania are strongly affected by economic policy. Despite advice from Lithuanian and foreign analysts, structural reforms in the energy sector, agriculture, pension and healthcare systems are still delayed, although an ever increasing number of specialists and politicians recognise their importance. Reforms are held back mostly because there is no consensus among different political actors as to what extent these areas should be open to market relationships and to what extent they should remain under state control and redistribution. To tell the truth, the direct tax burden in Lithuania doesn't exceed that in Latvia and Estonia, still, the tax system with all its three burdens is named by market participants as one of the biggest obstacles to economic growth. According to the World Bank survey, economy is mostly regulated in Lithuania.

According to the official statistics, agriculture generated 8.8 percent of GDP in 1999, although close to 20 percent of the total labour force were employed in this field. The first real step towards market relationships in the agricultural sector was made in the summer of 2000 by Kubilius Administration when the buy-up prices of milk were stopped to be regulated. In their political platforms, the right pro-reform parties propose measures applicable in the EU. These are elimination of minimal buy-up prices and granting subsidies to farmers as payments per hectare of cultivated land and the number of cattle, as well as implementation of interventionist buy-ups. Notwithstanding the fact that these measures, too, distort the market and induce ineffective development of agriculture, transition towards them would be more acceptable than the existing forms of government support.

In April, the Government approved conceptual pension reform plan that highlighted the need to form a three-pillar pension system by diverting part of social security contributions to private pension funds. However, during the first half of 2000 no decisions were made that would help reduce deficit of Social security fund and diminish obstacles to the establishment of pension funds and it seems that Sodra deficit will be a hard nut to this Government too, even if preparation for, and launching of, pension reform is fairly high on its agenda.

In the period under analysis, privatisation continued. Despite strengthening protests from the opposition, privatisation of the so-called strategic objects was not halted and the new Government underlines the importance to continue it. In its plan for the first one-hundred days, the Government included preparation of Constitutional amendments regarding land sales, which would allow all market participants to buy any type of land in Lithuania. Privatisation is going on, embracing objects of strategic infrastructure, however, there is a lack of openness and transparency in some cases, therefore, LFMI highly welcomes the Government's intentions to privatise objects through the Stock exchange and to abandon direct negotiations, which was the case with the privatisation of the Lithuanian Telecom company and the Mažeikių Nafta oil refinery. The direct negotiations allow the government to place restrictions on potential investors, while investors may manage to negotiate for preferential conditions and various benefits. This leads to inefficiency, artificial ownership concentration, a price increase and negative attitude of the people toward foreign investors.

Although foreign and local investors have equal rights in privatisation of state and municipal property, in practice, foreigners from Western countries usually are treated as more favourable investors.

At the legal level, there is a possibility that foreign investors will be granted privileges. For instance, the law on Investment and the law on Tax administration state that the Government of Lithuania has the right to make an investment agreement with the strategic investor, who invests more than 200 million litas where specific investment and business conditions as well as an exceptional tax regime are set.

Despite a pile of policy recommendations worked out by the Sunset and Sunrise Commissions under the Kubilius Administration, business regulations and extensive bureaucracy remain our daily companion.

The new government has the same obvious tasks: to reduce bureaucratic constraints to, and requirements for, business, to decrease the tax burden, to free labour relationships, to rationalise the flows of information and so on. The EU Commission also states in their report that "The authorities need to pass the amendments to the bankruptcy and restructuring laws and must subsequently ensure their effective implementation. The labour market needs to be made more flexible."

3. EU membership: inferiority complex of the younger brother

Talking about EU and Lithuania's preparation for membership, it should be noted that this task was set as the first in the Government plan for the first one-hundred days. Here it is most important to note, that preparation of negotiation positions for all chapters is not sufficient. Bearing in mind that preparation for integration can be successful only if people support it, it means that they have to understand the consequences. Economic consequences of integration into EU differ depending on the type of activity and concrete measures of adaptation. It is already clear that companies that already have wide and

intense relations and interests in Europe would benefit most, while those that were not going to extend their activities outside Lithuania and to increase the quality of their production would benefit the least. Integration offers Lithuanian firms new possibilities in exchange for new rules of the game that are stricter and can be more costly. If the possibilities are not used, the gains will be meagre, but the costs will be still real. The latter situation scares people most. Therefore, it is very important for everybody interested to investigate the real impact of EU integration, and for state institutions - not to misuse EU argument for grounding their own suggestions or actions.

4. Bids for how long this Government will hold out.

The ruling coalition of Liberals and Social liberals, as viewed from the point of view of economic values, is not the best fit indeed. That is one of the reasons why the Government program is inconsistent and at some points even contradictory. It is obvious that implementation of an eclectic program is usually even more eclectic. In a situation when strategic and thoroughgoing reforms are particularly needed in budget formation and government expenditures, taxation, pension system, education, health care and agriculture, a present wide range of opinions in the government is not favourable. Therefore it could be so that the reforms will not be going so well or even will not be started to the extent that was planned in the election program of liberals. But as long as the orientation of this Government is probably most pro-market and pro-business, it would be natural to expect steps towards deregulation and easing of the tax burden. How successful those steps are going to be will depend mainly on three factors: first, ability to agree among coalition partners in Government and Seimas; second, ability to get support from interest groups (that could neutralize the coalition which will act against anyway); and third, ability to get officials in the state institutions implementing political decisions in the right way. All the three items taken separately are not easy, taken altogether are even less so. But who can say that life of market participants is less difficult? In such a way it would be possible to explain why we are behind Estonians but not to justify that.