

1989–2009: the rise of the Lithuanian Baltic tiger?

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Plan:

1. introduction;
2. reasons for economic reforms;
3. reforms;
4. crisis in Russia;
5. EU entry;
6. economic growth 2000–2008;
7. crisis
8. forecasts;
9. conclusions.

1 Introduction

The Economist magazine in its article „Baltic tiger“ (published in July, 2003) described Lithuania’s highest growth in Europe, emphasizing achievements in economy (zero inflation, increasing exports, steady currency), but the same time noting numerous problems and comparatively low living standards.

The aim of the message – to investigate and summarize the road from planned to market-oriented economy (1989–2009) and make some assumptions on Lithuania’s future challenges in the time of the Crisis.

Let’s define what is a „tiger“ economy: the economy of a country which undergoes rapid economic growth, usually accompanied by an increase in the standard of living. The term was initially used for East Asian Tigers, and in the 1990s it was applied to the Republic of Ireland. Lately it was used to describe not only Lithuania, but also Estonia and Latvia – „Baltic tigers“.

2 Economic reforms

2.1 Reasons

During the early 1990s, the government launched a comprehensive program of market-oriented reforms, which included the privatization of state-owned enterprises, the lifting of

price controls, land reform, and reform of the banking sector. Also, a new national currency, the litas, was introduced in June 1993.

Key reasons:

1. the rate of inflation was very high in Lithuania because of the liberalization of prices control. Soviet Union had plan economy where prices were controlled: cheap food, transport and services on the one hand, and expensive clothing, electrical devices on the other. The collapse of the union liberalized prices, so, apparently they skyrocketed;
2. the Lithuanian government's expenditures were increasing and also it went beyond the amount of the government revenues;
3. wages decreased by 30% in 1992 compared to the previous year.

2.2 Privatization

Privatization occurred at a rapid rate in the 1992–1994 period (especially with respect to farmland, housing, and small enterprises), and about half of the large and medium-size enterprises scheduled for privatization were sold through public share offerings. To start the process, the law authorized the issuance of investment vouchers (in Lithuanian, „investiciniai čekiai“) to residents of Lithuania, to be used for the purchase of housing or other property. Most housing property eligible for privatization had been privatized by the end of 1993. Large enterprises also were to be privatized, with priority given to purchases of shares by employees of those enterprises. The number of shares that employees had the right to purchase in companies being privatized was increased in 1993 from 30 percent of total shares to 50 percent. By November 1994, more than 5,000 enterprises, or 80 percent of the assets earmarked for privatization, had been sold off.

Lithuania sought to regulate privatization of agriculture and to liquidate collective farms. The 1991 privatization law initiated agricultural land reform based on the proposition that nationalized land must be returned while unclaimed land could be sold to prospective private farms on long-term installment plans. Agricultural privatization proceeded rapidly; by the middle of 1993, some 83 percent of the agricultural privatization program had been completed.

Corruption and violence occasionally marred the privatization process. There were difficulties with auction sales of enterprises because speculators and organized crime conspired in bidding, bribed officials, or scared away competition with physical threats. Nevertheless, by the middle of 1994 the government had privatized state property worth a total of 489 million Litass, allocating the cash received to national and local privatization funds.

2.3 Price Restructuring

Inflation resulted from the lifting of price controls and from the shortages that resulted from trade disruption around the time of the collapse of the Soviet Union. Inflation, which was 225 percent in 1991, increased to 1,100 percent in 1992, fell to 409 percent in 1993, and dropped further to about 45 percent in 1994. Wages remained stable in 1991 but declined

30 percent in real terms in 1992. Prices increased several times more than wage and pension raises.

Prime Minister Adolfas Šleževičius coped with the high rate of inflation by avoiding the temptation to promise compensation to pensioners and others whose savings were wiped out by inflation. He also avoided giving in to demands for increased subsidies and support for utilities and public transportation, which traditionally had been provided by the central government. The opposition, led by former Prime Minister Gediminas Vagnorius, was pressing for compensation to savers and investors, but the public voted not to support the measure in an August 1994 referendum. These Lithuania's structural adjustment programs had been worked out in cooperation with the IMF.

2.4 Land Reform

The greatest difficulties in implementing Lithuania's privatization program were experienced in agriculture because rapid privatization caused fear and confusion in that sector. The laws provided for the dismemberment of collective farms but did not definitively ensure their replacement by at least equally productive private farms or corporations. The many small private farms that appeared on the landscape were inefficient. Conflicts frequently arose over title to land. Many new owners did not intend to cultivate the regained land or to actively engage in farming, and as a result tens of thousands of hectares were left fallow. Collective farm managers and their friends stole or cheaply acquired tractors, cattle, and other property.

2.5 Monetary and Fiscal Policy

The litas was introduced as the new national currency on June 25, 1993. It became the sole legal tender in August 1993. The litas has been stable since then, maintaining a value of 4.0 Litass = \$1 since its introduction.

Lithuania has made progress in reducing government expenditures to match government revenues. In March 1990, Lithuania began the difficult process of eliminating subsidies, introducing new taxes, and administering a new tax collection system. Personal income taxes, corporate profit taxes, and a value-added tax were introduced. The personal income tax rate ranges from 18 to 33 percent. The corporate profit tax rate is 29 percent, with a discounted rate of 24 percent on retained earnings and 10 percent on the earnings of agricultural enterprises. The VAT is 18 percent, and there are excise taxes on alcohol, tobacco, petroleum, furniture, jewelry, land, and other items and transactions. Lithuania has been reluctant to reduce its high tax burden for fear of fiscal instability, but high taxes have led to an environment that encourages underreporting and corruption, stimulating the underground economy.

The budget of the central government ran a deficit throughout the late 1980s. The amount of the deficit at that time was relatively small – about 3 percent of the gross domestic product. The central government ran a budget surplus of 3 percent of GDP in 1991. The budget had a surplus in 1993 but a slight deficit – 1 percent of GDP in 1994.

After independence in 1991, the government began to restructure its expenditures. Subsidies were reduced from 37 percent of government expenditures in 1985 to 6 percent in 1992, while expenditures for the social safety net (social security, welfare, housing, and communal activities) increased from 15 percent to 32 percent of expenditures over the same period. These shifts in expenditures are a result of the central government's assumption of responsibility for the social safety net from enterprises that had been responsible for them during the Soviet period. Projected government expenditures in 1995 equaled 26 percent of GDP.

2.6 Banking Sector Reform

Prime Minister Adolfo Šleževičius acknowledged that weakness in the banking sector was one of the most important challenges for his government and, if not properly supervised, could limit long-term economic growth. Lithuania needs to do more to live up to this commitment. Despite several bank failures, the number of banks increased from twenty to twenty-six from 1992 to 1994.

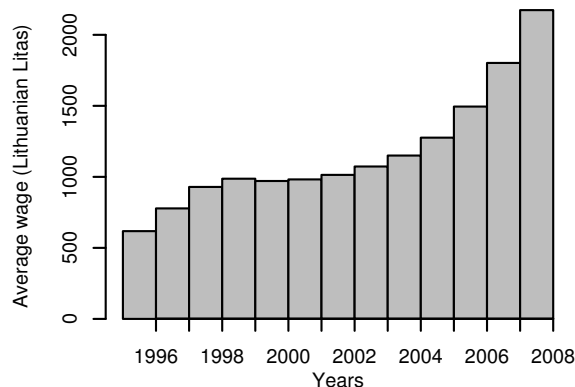
Significant factors guiding the reform of the banking sector are the technical advice and assistance of the IMF, which in October 1994 granted Lithuania a three-year US \$201 million credit, and the reforms required for membership in the European Union. The IMF has blamed the Bank of Lithuania's loose monetary policy in part for rising inflation. Some Western observers cite the central bank's institutional weakness and lack of autonomy as the main reasons for its ineffectiveness. The EU requirements are set forth in a white paper¹ that describes the sectoral conditions that each prospective member of the EU must satisfy prior to joining. These requirements touch on every sector of the economy. Membership in the EU was a primary goal of Lithuania's domestic and national security policies. The white paper requires an efficient and open financial market and a banking system that encourages market-directed capital flows. Member states are required to pass and implement legislation concerning the soundness of banking institutions.

Lithuania's 1994 reform program included a review of the bank licensing system, privatization of the three state banks (Savings Bank, Agricultural Bank, and State Commercial Bank), a review of capital requirements to ensure compliance with international standards, and the introduction of new plans for accounts at the Bank of Lithuania and for commercial banks. The program also called on the government to pass stronger bankruptcy legislation and to ensure its enforcement.

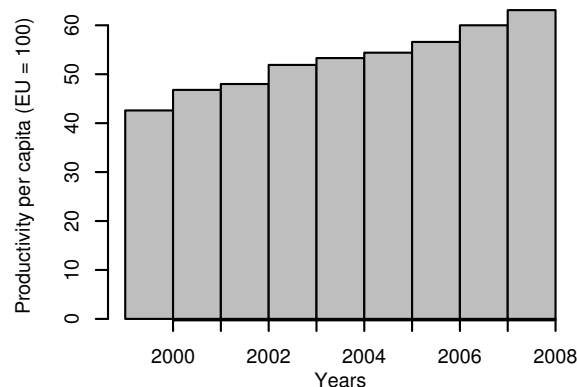
3 Crisis in Russia 1998

Lithuania is comparatively small and open economy which is dependant on foreign markets. Russian and Commonwealth of Independent States crisis in 1998–1999 affected country's economy because it was oriented to these countries, as a result GDP decreased 4.1% in 1999. Since the Russian monetary crisis, the focus of Lithuania's export markets has shifted from East to West. For instance, in 1997 exports to former Soviet states made up 45% of

¹A **white paper** is an authoritative report or guide that often addresses problems and how to solve them. White papers are used to educate readers and help people make decisions.



1 pav.: Average wage in 1996–2008 (Lithuanian Litas)



2 pav.: Productivity in 2000–2008

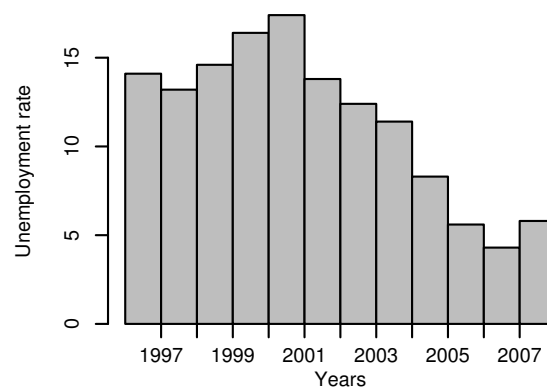
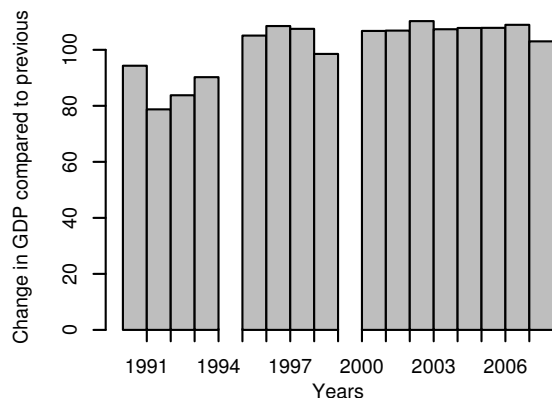
total Lithuanian exports. In 2005, exports to the East were only 18% of the total, while exports to EU members amounted to 65%. Even though Russian financial and economy crisis was negative for Lithuania’s economy, country’s macroeconomic environment (inflation, investments) remained attractive for structural changes.

4 EU

On February 2, 2002, the government re-pegged the Litas from the US dollar to the Euro at the rate of 3.4528 Litas for 1 Euro. The re-peg, which went smoothly, reflects a change in trade orientation and was meant to help Lithuania prepare for membership in the EU Economic and Monetary Union.

Lithuania has recorded impressive economic growth in recent years, which helped improve living standards. Rapid growth has helped Lithuania to catch-up to EU average income levels, with GDP per capita reaching almost 61.6 percent of EU25 average in 2008 – significantly up from 47 percent in 2003. Growth was driven almost entirely by domestic demand, encouraged by large real wage increases, rapid credit growth, and stimulus from EU grants. High growth also helped to significantly improve labor market outcomes with unemployment reduced to 4.4 percent in 2007 from over 13 percent in 2003.

As the economy expanded above its growth potential, overheating pressures mounted and significant external and internal imbalances developed. Both the current account deficit and inflation reached high levels, the latter complicating Lithuania’s Euro adoption plans (in May 2006 the EU rejected Lithuania’s application to join the Euro zone from January 2007, as inflation was marginally (0.1 percent) above the reference value). Furthermore, much of the rapid credit expansion was in foreign exchange and banks were taking on increasing exposures to real estate, which brought substantial risks to the banks’ assets quality and financial sector stability. The policy response to these imbalances was insufficient. Given Lithuania’s currency board arrangement, the focus was on fiscal policy which tended to be pro-cyclical and expansionary despite robust economic growth translating into good revenue performance. The fiscal balance remained in deficit in most years (reaching 1.2 percent of



3 pav.: Change in GDP compared to previous year in 1991–2008

4 pav.: Unemployment rate in 1997–2008

GDP in 2007).

5 The crisis and forecasts – challenges ahead

After a period of overheating, economic growth started to slow down rapidly, which, together with the impact of the global financial crisis, has caused some concerns about Lithuania's macroeconomic stability. As a result of economic overheating, 2008 saw a major economic slowdown and output growth turned negative (–2.2 percent year-on-year) in the fourth quarter. Risks to financial sector stability have further increased as a result of the recent global financial turmoil and related liquidity pressures. Furthermore, concerns have been raised about contagion risks from neighboring countries.

The government is taking fiscal tightening measures in an attempt to keep fiscal deficit within the Maastricht limit of 3 percent of GDP. Nevertheless, Lithuania's path of economic adjustment poses some risks for macroeconomic stability. As the expected slowdown in Lithuania's main trading partners undermines the outlook for exports, prospects of economic recovery remain bleak, with the economy set to contract 15 percent or more in 2009.

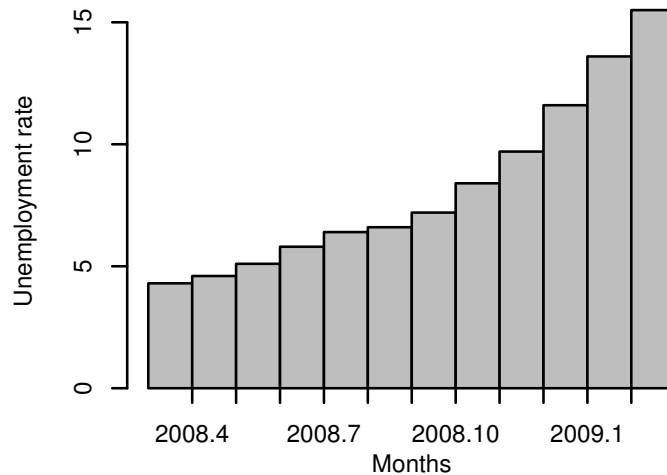
In the short term, mitigating the impacts of economic recession and the global financial crisis is the main challenge ahead. Strong domestic adjustment policies, including measures to stabilize public finances, will need to be implemented in order to unwind the accumulated imbalances. At the same time, one of the major challenges will be protecting the most vulnerable social groups from the impact of the ongoing economic crisis.

In the medium term, Euro adoption and sustainable convergence with the EU are the key goals, to be supported with further structural reforms and efforts to foster the creation of a knowledge economy as a way of increasing Lithuania's global competitiveness.

Closing „Ignalina“ power plant will result in more expensive electricity.

According to „Deutsche bank“ three problems made situation in the Baltic states complicated:

1. easy-to-get credits for real estate caused a bubble;



5 pav.: Unemployment rate April 2008 – March 2009

2. fast wage increase, high inflation and national currencies, pegged to euro, result in a loss in competitiveness;
3. irresponsible fiscal policy.

6 Summarizing and inferences

To sum up, necessary to mention these facts.

Economy blossomed and living standarts increased 2000–2008. This happened mainly due to foreign money streams: 1) EU funding, 2) bank loans and 3) money thansfered by immigrants which resulted in an increased domestic demand. Complicated reforms in early ninety's, joining EU and other factors made Baltic states countries with highest Human Development Index in the former Soviet Union.

However, overheated and contracting economy, world crisis are making macroeconomic stability risky, we see fast slowdown and quick recovery is hardly probable. Being an open economy Lithuania is dependant on partners in the European Union and influential neighbours like Russia.

In conclusion, situation in 2000–2008 was favourable, so, technically, can be named a „tiger“. However, financial crisis and consequences of overheated economics are making a „tiger“ status very disputable, at least for the nearest future.

7 Literature

Internet pages were accessed in April–May 2009. Almost all text was compiled from the following sources, however, not properly quoted:

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