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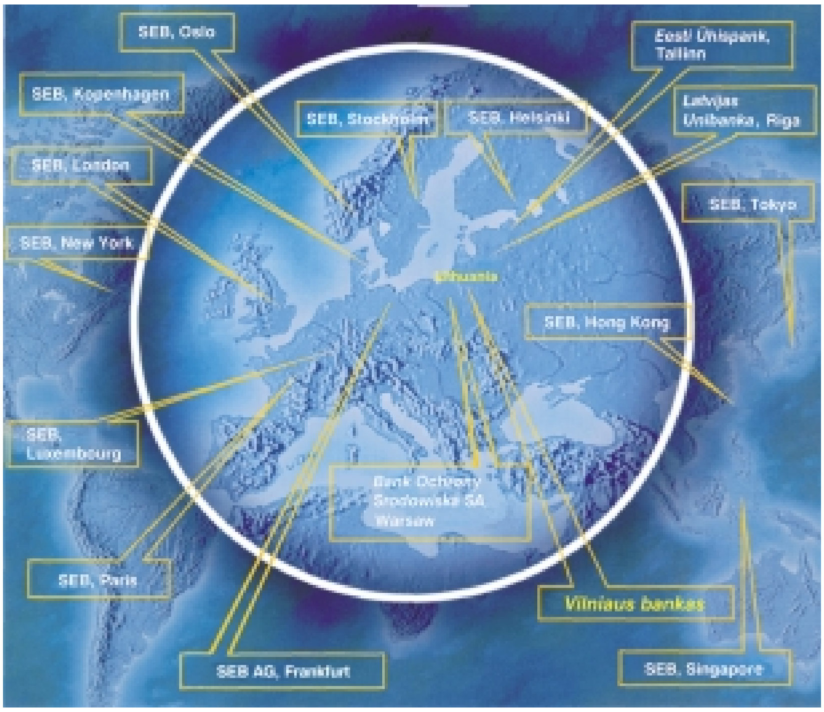

VILNIAUS BANKAS

MEMBER OF THE SEB GROUP

The sixth issue of *Lithuanian Macroeconomic Review* can be distinguished by its introduction of the economic activity indices and their forecasts for the main sectors of the Lithuanian economy. Henceforth, the indices will be released on a regular basis in order to meet the need for up-to-date information and to make the results of the indices compatible with each other. This issue features a special section on the upcoming date of re-pegging the litas from the US dollar to the euro and outlines the likely effects of this decision on the development of certain business activities. As in previous issues, the risk of litas devaluation is considered to be minimal. Nevertheless, given the fact that this question is broadly discussed, several possible outcomes of the devaluation in the main economic sectors are roughly simulated. As usually, this issue of *Lithuanian Macroeconomic Review* continues to cover such topics as the overall political and economic situation, development trends in external markets, main macroeconomic indicators, foreign trade, the balance of payments, certain economic activities of mining and manufacturing industries, financial markets, state debt and budget.

The publication refers to relevant data reported by the following institutions: Department of Statistics to the Government of the Republic of Lithuania (*Statistics Lithuania*), Ministry of Finance, Bank of Lithuania, National Stock Exchange of Lithuania, Lithuanian Labour Exchange, the news agency BNS, the newspapers *Lietuvos rytas*, *Verslo žinios* and other reliable sources.

Lithuanian Macroeconomic Review is a product of the *Vilniaus Bankas* economic research team:

Dr. Gitanas Nausėda	Phone:	(370 2) 68 25 17
CEO Adviser	Fax:	(370 2) 68 25 08
	E-mail:	g.nauseda@vb.lt
Prof. Rimantas Rudzkis	Phone:	(370 2) 68 25 18
Senior Analyst	E-mail:	r.rudzkis@vb.lt
Dr. Vadimas Titarenko	Phone:	(370 2) 68 25 21
Senior Analyst	E-mail:	v.titarenko@vb.lt
Algė Budrytė	Phone:	(370 2) 68 25 08
Analyst	E-mail:	a.budryte@vb.lt

Vilniaus bankas AB
12 Gedimino ave., LT-2600 Vilnius, Lithuania
Phone: (370 2) 68 28 00, fax (370 2) 62 65 57
Web site: www.vb.lt
REUTERS: VIBK
SWIFT: CBVI LT 2X

KEY POINTS

A majority of the public was concerned whether the new government of Social Democrats and Social Liberals headed by Algirdas Brazauskas would continue Lithuanian economic reforms. This uncertainty is not well grounded because the current government's ability to turn back is constrained by many pledges made previously in seeking to join the EU and NATO. Memberships in these international organisations remain an unquestionable priority of Lithuania's foreign policy.

A rather strong majority in the Seimas and more active co-ordination of coalition parties' activities ensure favourable background for prompt and sound political decisions. Another outcome of these conditions may be the longer stay of the new government in office.

At last the *Bank of Lithuania* announced the date and details of re-pegging the litas. Businessmen have six months to prepare for facing currency risk when the litas will no longer be fixed to the US dollar. Like in the past, the probability of devaluation is minimal.

Latest macroeconomic results show that the economy continues taking its run. Although external market developments are not overly optimistic and thus Lithuanian export prospects are not very bright, the domestic market is already recovering. Domestic demand was one of the factors driving GDP growth in the 1st quarter of 2001. In the 2nd quarter, GDP may rise even at a higher pace.

The results of exports and imports of services for the 1st quarter were favourable and blocked an increase in the current account deficit. After a quite long break, the import of investment goods was augmenting more rapidly than on the average and evidenced a growth trend of investment in the economy in general.

Last year proceeds from privatisation accounted for the largest share of FDI flow, while in the 1st quarter of 2001 the role of reinvestments grew in importance. In the near future, privatisation will become the dominant source of FDI again.

Despite of the government change, the forecast for the fiscal deficit of consolidated general government operations is not revised and remains about 1.5% of GDP in each 2001 and 2002. In 2003 the balance of the budget will be hardly achievable due to the beginning of pension reform and due to high demand for huge financial injections to compensate lost SoDra income.

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1. Overall Political and Economic Situation

1.1. Brief Review of the Political Situation

The results of elections to the Seimas that took place in autumn 2000 were favourable for the New Politics Bloc (the Liberal Union, the New Union (Social Liberals) and other smaller parties) to form a ruling majority. Unfortunately, the government led by Rolandas Paksas could not withstand the pressure of interest groups in the wake of strategic companies' privatisation and existed only for 8 months. Other reasons for the government's crash were poor co-ordination of coalition parties' activities and insufficient political discipline.

Furthermore, the importance of different ideologies should not be overlooked. The election program of Liberals emphasised the development of free market economy and the removal of business barriers. On the other hand, Social Liberals were focused on the development of socially oriented market economy. Social Liberals were hardly able to implement their program due to the stronger political power of Liberals (they had more mandates in the Seimas and more delegated ministers) and due to certain personal characteristics of Prime Minister Rolandas Paksas. The government was moving away from the Parliament. The Cabinet of Ministers became a certain closed club, poorly discussing its plans with coalition members in the Seimas and not even considering remarks by the opposition.

The logical end of the story was quick to come. Rolandas Paksas resigned on June 20, 2001 due to disagreements with the coalition partners. Essentially, there were three possible scenarios for the further development of Lithuanian politics.

First, Liberals could delegate a new Prime Minister, who undertook responsibility to form a new government. In the wake of government breakdown, Social Liberals declared about being mostly dissatisfied with the performance of Rolandas Paksas, and that a new Prime Minister could help to preserve the coalition. Indeed, the possibility of such scenario existed for some time. There was even a new candidate – Eugenijus Gentvilas, liberal "No. 2" – to take the Prime Minister's position. Unfortunately, this chance was missed because of the resistance of Rolandas Paksas and his followers. Nevertheless, if this scenario had come true, it would have been short-lived, since in reality the coalition had already split some time ago.

Under second scenario, the current President Valdas Adamkus could seek for premature elections to the Seimas in order to resolve the political "stalemate" and in that way to avoid a new coalition of Social Democrats and Social Liberals. The reluctance to let the mentioned coalition (of Social Democrats and Social Liberals) rule may be explained by the concern for coming strategic companies' privatisation, during which Lithuanian geopolitical interests could be hit as a result of too intensive Russian invasion. In such situation, the Lithuanian goals to become a member of the EU and NATO would suffer. On the other hand, premature elections are strong "medicine" that paralyses the work of executive and legislative powers for a long time. Furthermore, these elections could work at Social Democrats' advantage by strengthening their political weight, since public polls have been favouring their activities.

Third possible solution for the political crisis was to authorise Algirdas Brazauskas, ex-President who resigned a couple of years ago and leader of Social Democrats, to form a new government of Social Democrats and Social Liberals. The President chose this possibility, which was ***the only realistic and satisfactory way out of the existing situation.***

The composition of the government headed by Algirdas Brazauskas was established by a presidential decree on July 5. Social Democrats and Social Liberals dominate the new Cabinet of a leftist majority (the number of these political parties' mandates in the Parliament exceeds 70 and is enough to guarantee a majority of votes); nonetheless, there are some ministers who do not belong to any political party. Six out of thirteen ministers were members of the former government of Rolandas Paksas.

Domestic and foreign political reviewers have indicated the following main uncertainties associated with the new government: ambiguous policy with respect to the East, slowdown of economic reforms, excessive social obligations in terms of the state budget and etc. However, these concerns are based on general reasoning rather than on the contents of Lithuanian domestic and foreign policies.

Lithuania is in the presence of very important events – memberships in the EU and NATO. If neither membership were attained, this would be publicly treated as a loss of the whole country, not one party or ruling coalition. Both the Seimas majority and the opposition perfectly perceive these possible outcomes. Furthermore, in order to become a member in the mentioned international institutions, one has to do a tough "homework," tasks of which *a priori* establish the direction of foreign and domestic economic policies. Thus, ***the new government is far from having plenty of room for discretionary decision making, though it may appear so at first sight.***

Special attention should be given to the process of modifying social democratic ideas that has been going on in the world during late decade. Currently ruling Social Democrats (the government headed by Tony Blair, leader of the Labour Party in Great Britain; the Social Democratic-Green government headed by Gerhard Schroeder in Germany) focus on pragmatic policies based on the goal of winning next elections rather than on stagnant ideological dogmas. Furthermore, the processes of globalisation and e-society development, to a certain extent, stimulate the levelling of the political right and left. The Social Democratic Party of Lithuania is an active member of international social democratic organisations, and thus cannot ignore these global trends.

The collection of state budget income lags behind the economic recovery in Lithuania and sets the ceiling for spending on domestic, and particularly, public finance policies. On the other hand, agreements with international financial institutions (IMF, World bank) establish a narrow fiscal deficit limit, induce to start a reform of the pension system that will require huge funds to cover the budget deficit of SoDra and etc. Therefore, radical redistribution of public income and broad social programs are nearly impossible.

Furthermore, Social Democrats are not the only ruling authorities and thus will have to consider coalition partners' opinions when making certain decisions.

During the creation process of a government and its program some signs of political pragmatism became obvious. Even four ministers (of finance, economy, national defence and environment) were assigned in accordance to their professionalism rather than party-memberships. Social Liberals delegated six ministers, while Social Democrats – only three (without Algirdas Brazauskas), even though the ratio of seats in the Parliament suggested the opposite proportion. The political generosity of Social Democrats encourages Social Liberals and fortifies the government. Another factor contributing to consensus is the absence of alternatives for Social Liberals in a case of this government's split (having in mind the drastically shrinking political popularity of Social Liberals, premature elections would hardly benefit them).

Social Democrats have already made some compromises in designing the government program. They have stopped to unconditionally strive for the establishment of progressive income tax system. Instead, they intend to decrease the personal income tax, to increase the tax-exempt income minimum and to differentiate it by the number of family members and the handicapped. Nevertheless, it should be noticed that the planned decline in the personal income tax will exclusively affect the low-income population, and thus the idea of tax progression is being pressed for indirectly.

The new government plans to cancel subsidies for the corporate profit tax as well as to abolish this tax's payments in advance. New authorities do not support the idea of the ex-government to abolish the corporate profit tax. On the other hand, they intend to proceed with the policies of their predecessor and remove the corporate road tax on sale revenues as well as to enlarge the payment base of the real estate tax.

The new program of the government does not state anything about the previous claim by Social Democrats to maintain the state control in strategic companies that are being privatised. Such announcements by Social Democrats have used to initiate doubts about their adherence to the privatisation policy. The current government program advocates the "state influence" (rather than control) on strategic entities and the necessity to "stop harmful privatisation, when monopolistic companies of the infrastructure are being sold without preconditions protecting the Lithuanian consumer." It is envisaged to continue the privatisation process by attempting to sell state-owned equity through the stock exchange.

The intentions by the government to stick to stringent fiscal policy and to ensure the same conditions for both domestic and foreign investors should be interpreted positively. The government seeks to meet its international obligations of fiscal deficit and finance and to keep the total country debt as a % of GDP constant. This adherence will guarantee the stability of financial markets as well as well-rounded co-operation with the IMF and other influential international organisations.

As it was expected, the new program gives no surprises in the field of foreign policy. The government of Social Democrats and Social Liberals envisages continuing the former foreign policy of Lithuania and emphasises the importance of the goal to become a member of the EU and NATO. In addition, sound relations with neighbours and other countries are highly valued. The government aims to preserve the current pace of negotiations on EU membership and to close them in 2002. If this were achieved, Lithuania would become a fully qualified EU member in 2004. The goal of the country is to be ready for NATO membership in the nearest future and to be invited to join this organisation in 2002.

It is not envisaged to reduce financing the national defence. In this field, it is planned to follow international obligations and gradually establish a professional military service. In 2002, expenditures on the national defence should go up to 2% of GDP and henceforth should not decrease.

As opposed to its predecessor, the current government headed by Algirdas Brazauskas has better chances to stay in power until presidential elections in 2002 or even until the term of its office expires in 2004. The quite firm majority in the Seimas and probably more active co-ordination of coalition parties' activities may serve as government's trumps for prompter decision making.

1.2. Brief Review of the Economic Situation

A bunch of events that are crucial for the development of the Lithuanian economy and its financial markets happened in the discussed period. First, in June the Seimas approved the *Law on Mandatory Vehicle Liability Insurance*. Starting from April 2002, owners of transport vehicles will have to acquire auto insurance. This will notably enlarge the insurance market and stimulate the development of this financial sector. It is worth mentioning that up to this point Lithuania was the only country left without mandatory auto insurance among candidates to the EU.

Second, at least the political agreement on a model of *Lietuvos dujos* (*Lithuanian Gas*) privatisation has been reached. It is envisaged that after the privatisation the state will own the share stake of 34%, the strategic investor – 34% and the gas supplier – 24% of shares. Newly elected headquarters of *Lietuvos dujos* will decide to whom to delegate the right of control. The strategic investor is allowed to be a consortium consisting of foreign and domestic capital with equal participation rights.

Next, at the end of June, the provisional government headed by Eugenijus Gentvilas approved the agreement on long-term co-operation between *Williams International*, US company controlling *Mažeikių Nafta*,

Table 1.1

Industrial Confidence Index

2000							2001					
VI	VII	VIII	IX	X	XI	XII	I	II	III	IV	V	VI
–14	–18	–14	–10	–19	–17	–20	–16	–9	–0,3	2	–1	–8

and *Jukos*, Russian oil company. According to the agreement, *Jukos* has the right to acquire 26.85% of newly issued *Mažeikių Nafta* shares for US$ 75 million and will oblige to extend a loan of the same amount for the purpose of *Mažeikių Nafta* modernisation. The agreement assures that for 10 years *Jukos* will supply 4.8 million tons of oil to *Mažeikių Nafta* and will export additional 4 million tons of oil via *Būtingė terminal* per annum. If this agreement were successfully finalised, the supply of crude oil to *Mažeikių Nafta* would be guaranteed, and thus the latter would have an opportunity to start operating profitably.

Fourth, the *Bank of Lithuania* (BoL) has announced the plan for re-anchoring the litas. The litas will be pegged to the euro on February 2, 2002. The official exchange rate of the litas will be established on the basis of the euro and the US dollar exchange rate as recorded by the *European Central Bank* (ECB) on February 1, 2002, i.e. the litas is not going to be either revalued or devalued. ***With the presumption that in the nearest six months the euro has a quite poor chance to robustly appreciate against the US dollar, the litas may be fixed to the euro at a rate of approximately 3.5:1.***

This decision of the BoL winds up the process of repegging the litas, which has been dragged-on for too long and has been unhealthy for the Lithuanian economy. The depreciated euro against the US dollar has brought losses for businessmen trading with the EU. On the other hand, unprofitable activities have pushed to intensify production, to introduce new technologies and to cut costs. These developments should prove to be fruitful in the long run.

Fifth, international credit rating agencies have started to acknowledge the slowly brightening future of the Lithuanian economy. *Fitch* has increased its long-term foreign currency credit rating for Lithuania from BB+ to BBB- and short-term credit rating – from B to F3. *Fitch* has improved its credit ratings for the first time in four years.

Meanwhile the improved industrial confidence index (ICI), which is based on the main three factors of production growth forecasts for the horizon of the nearest 3–4 months, the level of demand for output and inventories of finished goods, has been stimulating optimistic business expectations. In the first half of 2001, the ICI average came to –5.4, while in the second half of last year the respective figure was –16.3 (see Table 1.1). In April of this year, the ICI was even positive. However, in May and June, the index became negative again, because surveyed managers speculated about the likely effect of coming summer. For instance, in May, 37% of the respondents anticipated production growth, 52% of the respondents forecasted no changes, and 16% of the respondents expected a decrease in production. In June, the corresponding shares were 27%, 57%, and 16%. Nevertheless, this is explained by seasonal fluctuations that cannot change the general positive trend.

The problem of insufficient demand for produced output remains urgent. In June, only 5% of the surveyed indicated that the demand for their output was higher than on the average, 61% of the surveyed considered it to be normal, and 34% of the surveyed complained about demand's shortage. Nevertheless, these shares show an improvement, because in January they accounted for 3%, 43% and 54%, respectively. An analysis of the third ICI factor, inventories of finished goods, suggests that the number of companies with insufficiently accumulated outputs has declined.

Certain optimistic expectations of businessmen have come true and encouraged more bold investments in production extension. In the 1st quarter of this year, after a long break, capital investment significantly went up. The import of investment goods surged even more.

In the period of last two years, trade by Lithuania with the EU rallied. The share of Lithuanian exports to this region exceeds 50%. Nonetheless, the more important qualitative achievement in terms of Lithuania's integration is the following. ***After the Russian crisis, many Lithuanian businessmen have established stable relationships with partners in the West, and therefore even the current slowdown of the EU economy cannot hinder their firm resolution to continue increasing exports.***

This time it might be concluded that the domestic demand contributes to the growth of the Lithuanian economy. If real earnings, the dynamics of loan portfolio and other factors that directly or indirectly reveal the situation in the domestic market reached the corresponding levels of Latvia and Estonia, annual GDP growth in Lithuania would be close to a two-digit number.

Last but not least, *Transparency International* – international non-governmental organisation – has declared good news for the business development in Lithuania. According to a survey performed by this organisation, corruption in the country has diminished. This year Lithuania was in 38th place, up from 43rd last time, by the corruption index among 91 countries of the world (Latvia took 59th and Estonia 28th places).

1.3. External Markets

The ***US economy*** has bottomed out and is likely to recover already in the 3rd or 4th quarter of this year. Although in the 1st quarter GDP increased by only

1.2%, the country succeeded in avoiding negative GDP changes, which could painfully hit expectations of consumers and investors. The anti-cyclical stance of monetary policy implemented by the Federal Reserve (Fed) has played an important role as well. In the last half of the year, the Fed lowered its target for the federal funds rate by even 275 basis points. The strong US dollar relative to other currencies of the world and quite low inflation were two favourable conditions enabling these brave steps undertaken by the Fed.

In the beginning of June, the current President of the U.S. George W. Bush signed the law assuring that income taxes are going to be cut by US$ 1.35 trillion in the nearest decade. In 2001, the tax burden is envisaged to decline by US$ 100 billion and a majority of income taxes will go down by 3 percentage points (p.p.). However, private consumption is not likely to grow by the same amount as taxes to fall, because households have already been familiar with these changes in tax policy and started to increase their expenditures in advance. Furthermore, the increased domestic demand will be met by depleting accumulated inventories first and only then – by extending production. Nevertheless, the fiscal policy of the new US administration is adequate to the current situation and will soften an envisaged slump in production.

In May, the number of non-agricultural workers decreased by additional 19 thousand (in March, the figure showed an increase of 59 thousand, and in April – a decrease of 182 thousand), but the unemployment rate dropped by 0.1 p.p. to 4.4%, too. The manufacturing industry was recovering from recession, and the number of discharged workers in May reached 124 thousand. In the sectors of wholesale and retail trade the number of dismissals came to 14 thousand and 5 thousand, respectively. In contrast, the number of the employed in construction went up by 31 thousand and in the mining industry – by 4 thousand. The number of workers in the service sector rose by 70 thousand.

The main dangers for the US economy are household saving and investment. In the first months of 2001, the saving rate was even negative. Plunging stock prices and the worsening situation in the labour market can encourage households to save a greater portion of their income in the future. As a result, consumption spending and solvent domestic demand may shrink. In addition, lately the high-tech sector (especially the IT business) has been glutted with investments. The decreasing number of orders for sector's output will unavoidably resolve in a painful fall in its investments.

As in the previous issue of* Lithuanian Macroeconomic Review*, the U.S. GDP is forecasted to grow by 1.6–2.0% in 2001 and by 2.0–2.3% in 2002.

The cooling-off of the U.S. economic conjuncture has emerged to be more harmful to the **euro zone** than it was expected in the very beginning. In the 1st quarter of this year, the euro zone's GDP showed an increase of 0.5% over a quarter (0.1 p.p. less than in the last quarter of 2000) and 2.5% over a year (0.4 p.p. less). The growth of household spending rose by 0.1 p.p. to 0.3%. On the contrary, investment plunged by 0.9%, despite the fact that it grew by 0.3% in the previous quarter. The growth of exports decelerated to 0.1% (it was 3% in the 4th quarter of the previous year).

According to a research on business and consumer confidence performed by the *European Commission*, in May the economic climate index fell by 0.4 points to 101.7 points for the fifth month in a row. In Belgium, Germany and France the index plummeted most sharply, while in Ireland, Spain and Netherlands it pointed upward.

The data cited above suggests that so far households are the best resistant to the recession, and private consumption continues to grow. This is the outcome of rising employment (in 2001, the unemployment rate is expected to decline from 8.9% to 8.3%) and tax-cut programs implemented in many countries.

In contrast, the slowing down growth rate of exports is troublesome. Even the very weak euro is helpless in this field. It is usually assumed that the euro zone is a relatively large and closed economy, and thus the effect of changes in international markets on the European economy should not be overestimated. Nevertheless, the growth rates of imports and exports remain important driving forces of the euro zone economy, reflecting the direction of its development. The growth rates of both imports and exports are expected to decelerate this year. Since the growth rate of exports is forecasted to slow down more sharply than that of imports, the current account balance will worsen.

It is worth mentioning that in 2000, for the first time after a break of 40 years, the euro zone's fiscal balance was in surplus and accounted for 0.3% of GDP. State debt shrank to the lower than 70% of GDP level. Excluding the proceeds from the sale of licences for mobile 3G telecommunication systems, the fiscal surplus turns into deficit of 0.7% of GDP. Nevertheless, the latter is still insignificant in comparison with previous years.

With the slowing-down economy, the *European Central Bank* (ECB) has found itself in the situation that cuts both ends. On the one hand, the ECB has to lower interest rates. On the other hand, the Bank cannot engage in such policy because of quite high inflation. The mouth and foot disease has contributed to the inflation level by directly lifting food prices. Fuel prices have accelerated as well due to soared prices of raw oil and due to almost utilised capacity of oil refineries. The prices of fuel are not likely to plunge until mid-summer.

Despite of the complicated current situation with inflation, the ECB should decrease the main refinancing interest rate. The euro zone inflation is basically structural, and therefore any efforts to fight it by stringent monetary policy may provoke even deeper depression. It is very likely that the ECB will carefully reduce the refinancing interest rate by 25 basis points to 4.25% as soon as the very first signs of inflation deceleration are obvious.

The macroeconomic interdependence of the euro zone and the U.S. has come out to be tenser than expected. Therefore, the GDP forecasts for 2001 and 2002 are revised downwards. ***The euro zone GDP is fore-***

casted to go up by 2.0–2.2% this year and by 2.5–2.7% next year. Inflation will continue to exceed the level targeted by the ECB and amount to about 2.5%. Nevertheless, in 2002 it will be lower than 2%.

In the light of other EMU countries, the ***German economy*** is out of shape, and this is bad news for Lithuanian exporters. The German economy obviously lost its vitality at the end of the previous year, which was when the growth rates of private consumption notably slowed down.

The limited purchasing power of households was the outcome of rising unemployment.

Statistical data is not encouraging. The German GDP rose by only 0.4% in the 1st quarter. The industrial production of the country scaled down by 2.9% in March and April, as compared to January and February. In May, the economic climate index demonstrated a decline of 0.7 points, i.e. more severe drop than in other euro zone countries. The activity index of the manufacturing industry, released by NTC *Research*, showed a decrease of 0.5 points as well. The index came to 48.8 points. Unfortunately, the value of the index less than 50 points indicates a decrease in the manufacturing industry's activity.

The government headed by Chancellor Gerhard Schroeder has started to implement its policy of tax cuts, and this should repress a decline in private consumption. Nevertheless, the outcomes of the policy are likely to be realised only next year.

Due to the unfavourable sequence of economic environment's determinants, the German GDP is expected to grow at a notably slower pace than in the rest of the euro zone. ***The growth of GDP is forecasted to reach 1.6–1.8% in 2001 and 2.2–2.4% in 2002.***

As usually, oil prices in the world and the rouble exchange rate have a crucial influence on the ***Russian economy*** by determining the internal and external competitiveness of its goods. It is worth noting, however, that the factor of the rouble exchange rate should not be overestimated, because the country is huge and relatively closed. This year the growth of the Russian economy has been slowing down. One of the reasons for its deceleration is the amazing economic result of 2000 rather than "hard landing" scenario. After positive developments in the real sector, the consolidation process has started in the commercial bank system and the securities market, too. ***In 2000, the Russian economy opened new export opportunities for Lithuanian businessmen. In 2001–2002, the Russian market is expected to gain confidence.***

In the beginning of June, the Russian government approved the blueprint of the federal budget project for 2002. The budget is planned under the assumptions that real GDP will grow at a pace of 3.5–4%, inflation will reach 12%, and the average RUR/US$ rate will come to 31.5. Even though Russian authorities expect that the price of "Ural" oil should not be less than US$ 22 per barrel in international markets in 2002, they have based their budget estimations at a conservative price of US$ 17 per barrel.

According to preliminary calculations, in 2002 the revenues of the federal treasury will reach RUR 1.642 trillion (US$52.1 billion), and its expenditures will total RUR 1.513 trillion (US$ 48.0 billion). Thus, the budget is planned to be in surplus, i.e. 1.26% of GDP. Russia has to repay huge amounts of loans to its foreign creditors in the nearest future, and intends to meet its financial obligations beyond any doubt.

Rising official international reserves is another positive indicator of the Russian economic development. Official international reserves grew by almost 20% during the 5-month period of this year and added up to US$ 33.550 billion at the end of May. In May, inflation plummeted to 1.6%, though the 5-month figure was 10.9%, i.e. almost doubled as compared to the respective period of last year (6.8%).

Russia continues to export oil intensively. In the period from January to June, the export of oil amounted to 73.497 million tons and showed an increase of 7.7% over the first half of 2000. This rise in volume offset a decrease in the world prices of oil and guaranteed nearly stable export proceeds.

The main causes for rising prices in the country are of structural origin: an increase in utilities' prices that have been unnaturally low for a quite long time, monopolistic and oligopolistic powers in price determination, etc. In general, the process of domestic and external price convergence is taking place and may last for several years. To a certain extent, the current situation in Russia reminds Lithuania in 1994–1996, which was when the latter showed much higher inflation than the U.S. even though the litas was fixed to the US dollar.

The forecast for the Russian economic growth remains the same as given in the previous issue of *Lithuanian Macroeconomic Review*. ***The Russian GDP is expected to increase by 3.5–4.0% in 2001. In 2002, the economy may grow at a similar pace. The forecast for this year's inflation is slightly revised upwards to 15–17%.***

The ***Latvian economy*** proved its potency particularly in the last quarter of the previous year, which was when real GDP grew by almost 10%. Lately the political situation has somewhat stabilised, and the probability that the government leaded by Andris Berzins is going to stay in power until parliamentary elections in October 2002 has increased. Party *Latvia's Way* and the current Prime Minister have succeeded in settling discords within the ruling coalition and have united powers. The toughest exam for the coalition is going to be the policy of privatisation, the sale of *Latvijas Kuginieciba* (*Latvian Shipping Company*) in first place. Coalition partners may disagree on sketching the budget for the next year, too. In the middle of June, the government approved a draft of the revised law on the state budget for 2001. The draft upgrades the forecasted fiscal deficit for this year from 1.68 to 1.81% of GDP.

In April, the Latvian industrial production at constant prices showed an increase of 10.5% over a year. The economic activity index (estimated on the basis of inflation, unemployment, changes in foreign trade, and other indicators) rose by 12.3% per annum. As at the close of the previous year, in the 1st quarter of 2001, the growth of GDP was significant, i.e. 8.2%.

Certain economic characteristics show that the domestic market of Latvia continues taking its run. In the 1st quarter of this year, as compared to the corresponding period of last year, wages rose at a higher pace than the prices of consumption goods and services. Average earnings before taxes in the public sector increased by 5.3% and average earnings after taxes – by 4.9%, while annual inflation accounted for only 1.1%. The turnover of retail trade grew by 14%. The sales of new cars have been turning up as well. In the 5-month period of this year, this indicator demonstrated an increase of 2,962 passenger cars or 8.9% over the same period of last year.

In 2001, the domestic market will be the engine of economic growth in Latvia, since the progress prospects of exports are less encouraging than in the previous year. The main export partners of Latvia are Great Britain (17% of total exports), Germany (17%) and Sweden (11%), i.e. countries characterised by a notable economic slowdown. The depreciating pound sterling has been another barrier for Latvian exports to Great Britain. Goods with an insignificant value-added continue to dominate in the structure of Latvian exports: food products, timber, textiles, etc. In contrast, goods that are more complex technologically are mainly imported: transport equipment, electronics, etc.

On the one hand, conditions for Latvian exports have worsened. On the other hand, the reviving economy induces demand for oil, gas, investment goods and other imports. As a consequence, this year the current account deficit is not likely to be enormously different from the last year's figure, i.e. 6.8% of GDP.

Since the factor of the livened up domestic market is going to offset a slowdown in the euro zone countries and other main foreign trade partners of Latvia, economic forecasts for 2001 and 2002 are not revised. ***The Latvian GDP is expected to increase by 5.5–6.0% in 2001 and about 5.0% in 2002.***

Political stability and the direction of general reforms reached by consensus of major parties have always played an important role in the development of the ***Estonian economy***. Lately the political situation has been shaken. The parties of the ruling coalition – *Pro Patria*, *Reform* and Moderates – are not able to agree on certain social issues. The popularity ratings of the government are in the lowest levels of late years. The political destiny of Juri Mois, mayor of Tallinn appointed by *Pro Patria*, has been another blow for the ruling coalition. The politician has been forced to resign due to his suspicious relations with criminal authorities and due to absolute unpopularity. According to sociological survey results, the public approval rating of Centrists that are in opposition and skilfully make use of ruling powers' mistakes is the highest.

Presidential elections are scheduled for September of this year and are likely to be an interesting case. In Estonia the President is elected by the electoral board, consisting of members of the Parliament and about 300 municipal representatives. Public polls show that Toomas Savi, candidate of the Reform Party, and Peeter Tulviste, candidate of *Pro Patria* (even though the latter is only fourth most popular party), have the best chances to win.

The growth rates of the Estonian economy are slackening as expected. In the 1st quarter of 2001, the Estonian real GDP demonstrated an increase of 5.8%, while last year GDP grew by 6.4%. In the said quarter, the construction sector was numb, even though it increased by 30% in the 4th quarter of last year. The future of Estonian exports has somewhat darkened as a result of more modest economic expansion in the main foreign trade partners (Finland and Sweden).

The growth rates of exports decelerated from 68% in the 4th quarter of last year to 33% in the 1st quarter of this year. The respective figures of imports were 50% and 32%. In turn, the deficit of foreign trade broadened by about 30%. In April, the situation did not improve, since exports showed an increase of only 19% and imports – of 24% over a year. Nevertheless, in May, exports overtook the lead and grew faster than imports.

Trends in the balance of services are more cumbersome. In January–April of this year, the turnover of Estonian railroad loads shrank by 3.5% as compared to the corresponding period of the previous year. In the 1st quarter of 2001, the volume of Tallinn port's freight demonstrated a decrease of 2% over a year. In April and May, this indicator slightly improved due to liquid (oil) cargo transit in first place.

Although during the first four months of this year the consolidated state budget was in surplus (0.2% of GDP forecast), the plan of budget revenues is hardly met. According to provisional data, in January–June, it was accomplished only 48.6% of the plan.

So far the situation in the domestic market is not troublesome. In the 1st quarter of 2001, the turnover of retail trade rose by 12.1%, and average earnings increased by even more, 13.3%. The unemployment rate settled at slightly above 14%. The potential of private consumption is high, but its growth rates may slow down (this was already recorded in the 4th quarter of 2000, when private consumption expanded by only 6.1%) as a result of economy's "cooling-off," unmet expectations of households and businesses, and the lower propensity to consume. In May, inflation showed an increase of 6.9% over a year and hindered a rise in real earnings.

Government spending is bounded by stringent fiscal policy, and this situation is not likely to radically change in the nearest future.

In the light of negative characteristics of the Estonian economic development mentioned above, the forecast for this year's GDP growth is downgraded from 5.5% to 5.0%. In 2002, the Estonian GDP is expected to rise by 4.5–5.0%.

The ***Polish economy*** is on the brink of recession provoked by the strong zlot, high real interest rates and too quickly falling inflation. Slackening external markets have been bringing about export problems. The domestic market is not in its best shape as well. High unemployment and restrictive fiscal policy impede consumption growth. Last year the central bank tried to neutralise the effect of expansionary fiscal policy on the current account deficit and inflation and lifted the base interest rate a couple of times. This year the short-term interest rates were decreased by 250 basis points, though they remain ones of the highest in the region. In the first half of 2001, GDP is expected to grow by 1.5%.

In the second half of 2001, the policy of cutting interest rates is likely to be continued, especially having in mind that annual inflation plunged to 6%. Politicians and businessmen put pressure on the national bank of Poland by charging it with the decelerating economic growth and rising unemployment in the country. Anyway, the impulses of monetary policy reach the real sector with a time lag of one year or so and thus can hardly improve the economic growth result of this year. The Polish government expects that this year GDP will rise by approximately 2% and will gain some more speed in 2002. Average annual inflation is anticipated to scale down from 6% in 2001 to 5.5% in 2002.

In regard to the above-indicated factors, the Polish GDP is forecasted to grow at a lower pace than it is stated in the previous issue of *Lithuanian Macroeconomic Review*. ***GDP growth is expected to end up at 2.0–2.5% in 2001 and 3.0–3.5% in 2002.***

2. Main Macroeconomic Indicators

In the 1st quarter of 2001, main macroeconomic indicators moved in opposite directions. Nevertheless, ***it is obvious that the economy continues taking its run.*** Real GDP growth, production sales of mining and manufacturing, exports and etc. (see Table 2.1) indicated the improved economic conjuncture. It is worth noting, however, that in the future Lithuanian companies focusing on foreign trade will have to bid farewell to their golden age of the year 2000. Not accidentally, the year 2000 is called the flourishing time of the international economy.

In contrast to the 1st quarter of 2000, in the same quarter of 2001 the role of domestic consumption for GDP growth grew in importance. However, not all components of domestic demand contributed equally. While private consumption and gross investment pointed upward, government spending decreased due to adherence to stringent fiscal policy. In years to come, the reviving domestic market will accompany the still effective driving force of exports, and this may resolve in robust GDP growth. The economic advantages of pending Lithuanian membership in the EU will serve as an additional stimulus.

Latest financial and monetary data is also encouraging. Despite of the slowing down growth rates of ex-

Table 2.1

Main Macroeconomic Indicators of Lithuania

Indicator	1998 IQ	Annual change, %	1999 IQ	Annual change, %	2000 IQ	Annual change, %	2001 IQ	Annual change, %
Real GDP		8.5		–1.6		4.1		4.4
Nominal GDP (LTL billion)	9.401	19.3	9.294	–1.1	10.104	8.7	10.684	5.7
Production sales of mining and manufacturing industries at current prices (LTL billion)	4.663	17.9	4.013	–14.5	5.267	31.2	5.700	8.2
Exports of goods and services (LTL billion)	5.132	13.5	3.930	–23.4	4.855	23.5	5.597	15.3
Imports of goods and services (LTL billion)	6.001	12.0	4.587	–23.6	5.365	17.0	5.965	11.2
Current account deficit, % of GDP	9.7		8.1		5.7		5.4	
Fiscal balance of general government operations, % of GDP	–0.4*		–6.2		–4.2		–0.9	
Inflation (CPI change, %)	1.9		0.8		1.3		0.5	
Average monthly earnings (LTL)**	917	28.5	1.018	11.0	1.028	1.0	1.041	1.3
Average interest rates on loans in litas (%)**	12.0		12.9		13.9		10.6	
Unemployment rate (%)**	7.5		8.5		11.4		13.2	
Official international reserves (US$ billion)**	1.149	33.0	1.467	27.6	1.382	–5.8	1.287	–6.9
M1 (LTL billion)**	4.860	35.1	5.205	7.1	4.943	–5.0	5.298	7.2
M2 (LTL billion)**	7.141	28.6	8.143	14.0	8.885	9.1	10.612	19.4

* Taken as the average of the annual deficit

** End-of-period

ports, the current account deficit shrank from 5.7% of GDP in the 1st quarter of 2000 to 5.4% of GDP in 1st quarter of this year. The fiscal deficit of consolidated general government operations contracted from 4.2% to 0.9% of GDP. Inflation decelerated from 1.3% to 0.5%, but one should keep in mind that in January 2000 it reached 1.5% as a consequence of raised electricity prices. In the rest of 2000, deflationary tendencies were dominant. The situation is different this year, since prices are rising nearly every month. Furthermore, food products have started to go up in price, while last year they were becoming cheaper.

In contrast to the 1st quarter of 2000, in the discussed period of 2001, both the monetary aggregate M1 and broad money M2 turned up. Interest rates on loans in litas declined by even 3.3 points (p.p.). As a result, the terms of bank loans to businessmen and households improved.

Diagram 2.1 gives real GDP changes in the 1st quarters of 1997–2001.

The growth rates of real GDP were quite mighty in the 1st quarter of 2001 and are likely to go up even more in the 2nd quarter. The development tendencies of both certain economic sectors and exports support this hypothesis.

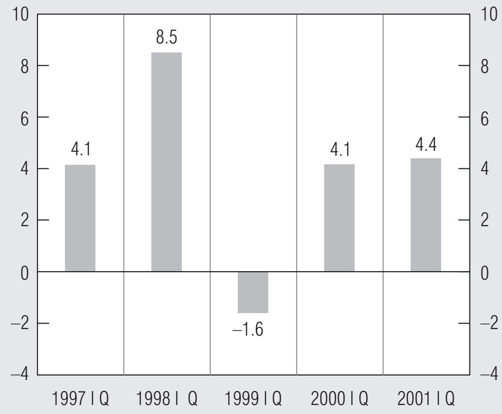
Already in mid-2000, in its publication *Lithuanian Macroeconomic Review*, *Vilniaus bankas* forecasted that in 2001 real GDP would rise at a pace of 4.2%. Among other official and private forecasts, this projection was one of the most optimistic (expectations ranged from 3.0% to 4.8%). To a certain extent, changes in external and internal environments of late years have already evidenced this forecast.

The forecast for real GDP growth in 2001 is not revised. Nevertheless, the probability that the actual result will exceed its projection has increased. In 2002, GDP is expected to rise by a larger number, 4.5%. The ambiguous ending of the American recession and the scope of its influence on the external markets of Lithuania may resolve in certain revisions. Despite of this possibility, it is quite realistic that the growth rates of GDP in 2002 will be higher that forecasted.

The tendencies of the first months of 2001 suggest that this year (like in the previous year) the current account deficit (CAD) is not going to cause any serious problems for the country's macroeconomic stability. Although in the 1st quarter the growth rates of imports caught up with the growth rates of exports, the balance of services was in huge surplus and had a positive effect on the CAD (see Appendix, Table B.3). The results of foreign trade for April and June were also optimistic. The exports of oil products, furniture, textiles and many other goods continued to point upward. The tourism sector vigorously recovered due to seasonal fluctuations. Imports mainly expanded on the back of investment goods. In the 2nd quarter of this year, the CAD to GDP ratio is likely to stay as it was in the 1st quarter or even to slightly diminish.

Diagram 2.1

Annual Changes in Real GDP (%)



***The CAD as a % of GDP is forecasted reach 6.5% in 2001. Although the probability that the actual result will be better than expected has increased, the forecasted ratio is not downgraded. In 2002, the CAD to GDP ratio is forecasted to account to 7.0%, i.e. the same projection as in the previous issue of* Lithuanian Macroeconomic Review.**

The ability of the new government headed by Algirdas Brazauskas to raise the fiscal deficit is limited by the signed agreement with the *International Monetary Fund* (IMF) that outlines economic policy for 2001–2002. According to the official forecasts, the fiscal deficit of consolidated general government operations is expected to reach 1.4% of GDP in 2001 and 1.3% of GDP in 2002. The band for fluctuations tolerated by international institutions comes to about 0.5%, i.e. if the deficit went up by such an amount, they would not be in hurry to conclude about the close of financial discipline, given that this bias has sound arguments.

Therefore, ***the government change is not likely to affect the fiscal deficit, and there are no grounds to revise its forecast. In each 2001 and 2002, the fiscal deficit is projected to amount to 1.5% of GDP. In 2003, it will be quite difficult to keep the budget in balance due to envisaged reform of the pension system and due to high demand for huge financial injections to compensate lost SoDra income.***

This year, inflation is anticipated to be higher than in 2000, when the main its cause was electricity prices that were raised at the start of the year. In the first months of 2001, structural and "cost-push" factors (diminishing oversupply of food products, to a certain extent affected by the mouth and foot disease in Western Europe, monopolistic price setting in the market of cable communications, etc.) were the essential determinants of inflation, while the "demand-pull" factor has not played its role so far. Average earnings continue to gradually increase and are easily compensated by improved labour productivity. The euro-US dollar exchange rate has a neutral influence.

Table 2.2

Forecasts for the Main Macroeconomic Indicators of Lithuania

	2001**	Annual change in 2001, %	2002	Annual change in 2002, %
Real GDP		4.2(↑)		4.5
Nominal GDP (LTL billion)	47.85	6.5(↑)	51.44	7.5
Current account deficit, % of GDP	6.5(–)		7.0	
Fiscal balance of general government operations, % of GDP	–1.5(–)		–1.5	
Inflation (CPI change, %)	1.8(–)		2.8	
Average monthly earnings (LTL)*	1,180(–)	3.7(–)	1,230	4.2
Average interest rates on loans in litas (%)*	11.0(↓)		10.0	
Unemployment rate (%)*	13.0(↓)		12.5	

* End-of-period

** Forecast bias is being evaluated. If a number is marked with ↑, it is very likely that an actual value will exceed its projection. The opposite is true, if ↓ appears next to a forecasted value. The sign (–) indicates that actual results are expected to deviate from their prognosis minimally.

In months to come, seasonal regularities (new agricultural harvest, rising demand for summer season's goods and services, etc.) will press for changes in the price level. ***At the end of this year, the Consumer price index (CPI) is forecasted to show an increase of 1.8% over a year. In 2002, the respective figure is likely to reach 2.8%. The probability that the actual CPI in 2001 will be higher than projected has increased.***

It is quite difficult to provide a prompt analysis of latest developments in the labour market in terms of labour costs, because *Statistics Lithuania* has stopped to release monthly data on average earnings and has decided to do this on a quarterly basis. In the 1st quarter, average wages demonstrated an increase of only 1.3% and were far from reaching the forecasted growth of 3.7%. Nevertheless, this projection is not downgraded and is still considered realistic because of the dynamic development of main economic activities, augmenting investment and the surging number of (temporal and permanent) job offers.

Average nominal earnings are projected to rise by 3.7% in 2001 and by 4.2% in 2002.

In January–May 2001, average interest rates continued to slip down. The announced plan for re-pegging the litas can hardly break this trend. The probability that interest rates will bottom out or even start increasing as a result of the revived credit market is likely, though not observable yet. Meanwhile companies prefer their own sources to finance capital investment. Like it was claimed in the past, it is realistic that in the wake of envisaged re-anchoring of the litas, interest rates will temporarily hop off and then subside right after the sound implementation of these monetary decisions.

At the end of 2001, average interest rates on loans in litas are forecasted to come to about 11%. At the end of 2002, they are likely to account for approximately 10%. It is worth men-

Table 2.3

Macroeconomic Indicators of the Baltic States and Some CEFTA Countries in the 1st Quarter of 2001

	Real GDP growth, as compared with the corresponding period of the previous year (%)	Rise in consumer prices, as compared with the corresponding period of the previous year (%)	Unemployment rate (%, end-of-period)	Current account deficit, % of GDP
Lithuania	**4.4**	**0.1**	**16.1***	**5.4**
Latvia	8.2	1.1	13.5*	4.1
Estonia	5.8	5.9	14.2*	7.0
Czech Republic	3.8	4.1	8.7	5.5
Poland	2.3	6.7	15.9	5.4
Hungary	4.4	10.3	5.6	2.7

Sources: Economic Indicators for Eastern Europe. *Bank for International Settlements*, April 2001; web sites of central banks.

* Based on labour market surveys; The Lithuanian unemployment rate was recorded at the end of 2000.

tioning that in the first months of this year interest rates declined by more that expected. Therefore, the above-indicated forecasts are moderately pessimistic.

In April–June, the rate of unemployment (based on the number of the officially registered unemployed) went down from 13.2% to 12.1% and was notably lesser than the forecast released by *Vilniaus bankas* (13%). The improved situation in the labour market was the outcome of seasonal fluctuations and temporal instruments applied by the agency *Labour Exchange* to increase the supply of jobs. Thus, in autumn and winter, unemployment may slightly turn up.

On the other hand, the principal question is whether it is worth to forecast the indicator of unemployment, if it is determined not only by objective, but also by subjective factors of essential influence that are hardly predictable and generated by human motivation. For instance, in 2000 the unemployment rate rose not only because companies had improved their production efficiency and cut labour costs, but also due to the fact that the jobless had started to increasingly register with labour agencies in order to avoid being kicked out of the social support system.

This issue of* Lithuanian Macroeconomic Review *leaves the forecast of unemployment unchanged. The rate of unemployment is expected to end up at 13.0% in 2001 and 12.5% in 2002. In the future, this indicator will be analysed on the basis of the number of people looking for a job. *Statistics Lithuania* compiles such data by regularly surveying households.

Table 2.3 shows the relative economic position of Lithuania in the light of certain countries of Central and Eastern Europe.

3. GDP Structure

Signs of economic recovery that became evident a year ago stepped into this year as well. Many analysts have forecasted that in the 1st quarter and in the rest of 2001, GDP will increase by no more than 4% due to relatively large figures in the 1st quarter of 2000 and due to the sluggish domestic market. However, the probability that these forecasts will come true is insignificant.

Like in the previous year, in the 1st quarter of 2001, the mining and manufacturing industry was the main driving force of the economy. The share of its value added came to even 25.7% (of the total value added by the country). Furthermore, the mining and manufacturing industry grew at the highest pace. The value added at constant prices rose by 14.5%. Swift export growth continued to induce the industrial development. Domestic trade, second largest economic activity, did not drowse as well. Its value added showed an increase of 7.4%. Unfortunately, the respective figure of the energy sector fell for the ninth consecutive quarter. Nevertheless, the latest decline was the smallest and totalled 1.8% (see Table 3.1).

Table 3.1

Value Added by Economic Sectors (at current prices, LTL million)

	1998 IQ	1999 IQ	2000 IQ	2001 IQ	Share in 2001 IQ, %	Annual change at constant prices in 2001 IQ, %
Total value added*	**8,291.6**	**8,261.0**	**9,204.8**	**9,711.8**	**100.0**	**4.2**
Agriculture, hunting and forestry	671.4	539.7	548.0	538.5	5.5	–7.1
Mining industry	27.3	18.7	62.4	102.0	1.1	46.7
Manufacturing industry	1,761.7	1,441.1	2,054.1	2,389.9	24.6	13.8
Electricity, gas and water supply	470.6	556.2	570.7	563.1	5.8	–1.8
Construction	520.7	490.8	389.0	380.2	3.9	–4.0
Domestic trade	1,397.4	1,307.9	1,329.3	1,408.8	14.5	7.4
Hotels and restaurants	119.0	125.1	119.4	120.5	1.2	–1.2
Transport and communications	861.4	949.2	1,147.3	1,211.2	12.5	0.3
Financial intermediation	218.1	167.9	225.4	249.4	2.6	1.7
Real estate, renting; Other business activities	669.7	791.6	819.6	811.5	8.4	2.0
Public administration and defence; Compulsory social insurance	501.3	595.2	619.2	601.3	6.2	–3.1
Education	503.0	617.8	647.9	646.8	6.7	0.2
Health and social works	316.1	368.3	366.5	377.3	3.9	2.3
Other activities	253.9	291.5	305.8	311.2	3.2	–1.2

* GDP equals the sum of all values added (total value added) plus taxes on products minus financial intermediation services and subsidies.

The value added by the transport and communications sector almost stayed constant. Although the value added by communications grew by 3.8% and goods traffic by roads surged as well, railroad transport services contracted and pulled the total indicator of the sector down. Transportation by railroads became less attractive, mainly because Russia had changed its tariffs for freightage in the direction of Klaipėda. So far negotiations between Lithuania and Russia on this matter have not been fruitful. In 2000, the services of railroad transport were one of the contributors to GDP growth. However, in the first half of 2001, they acted as stumbling blocks. If the question of tariff policy were solved, the situation would essentially improve.

Quite unexpectedly, the value added by agriculture shrank by even 7.1% in the 1st quarter of 2001. In 2000, after a long break, this sector slightly increased, and the rising export of food products seemed to be rather encouraging. These expectations have not been met. Nevertheless, the currently accelerating prices of livestock buying-up are good news for cattle breeders. The agricultural sector is constantly getting rid of one of its main discrepancies – oversupply.

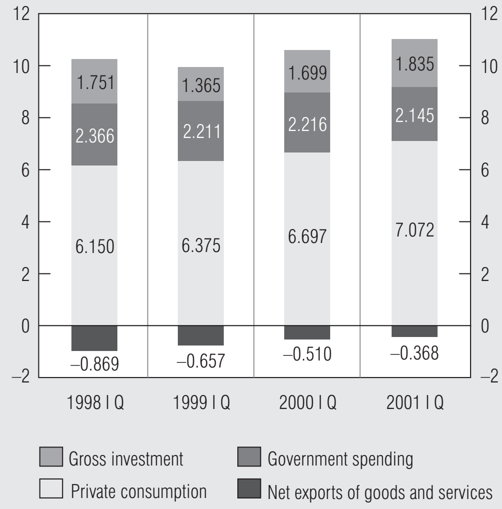
The indicators of construction fluctuated similarly to the indicators of the energy sector. The value added by construction decreased for the ninth quarter in a row, and the last decline was the smallest, 4%. Since capital investment started to rise at the end of the previous year and continued to do so in the beginning of this year, the construction sector is likely to stabilise or even modestly go up in the near future. The rising number of permits issued for new constructions supports this likelihood.

To conclude, the real sector's results for the 1st quarter were quite good. Furthermore, the real sector may grow at an even more rapid pace in quarters to come. Unfortunately, other economic activities remained being numb. In the 1st quarter of 2001, the values added by financial intermediation and real estate, renting and other business activities turned up by insignificant 1.7% and 2.0%, respectively. The value added by hotels and restaurants decreased by 1.2%. The economic activities of the public sector behaved similarly. The value added by public administration and defence, education, health and other social works plummeted by 0.7%. This explains why, despite of robust industrial development and good foreign trade results, Lithuania lags behind other Baltic States by GDP growth rates. Of course, the development of social infrastructure is important not only by itself but also as a factor of production growth.

Although consumer prices have not sharply fluctuated over recent years, an analysis of changes in nominal GDP is instructive, especially having in mind that fiscal policy is formed on the basis of this indicator. In the 1st quarter of 2001, nominal GDP grew by 5.7%, i.e. by more than on the average last year (5.3%). Furthermore, nominal GDP is very likely to rise at a higher pace in the rest of 2001. An analysis of GDP by spending approach renders grounds for this forecast to come true.

Diagram 3.1

GDP by Spending Approach (LTL billion)



This year private consumption grew faster than it did in 2000. In the 1st quarter of 2001, it showed an increase of 5.6% over a year. In contrast, government spending shrank by 3.2% and suggested that fiscal policy had become even tighter. It is not likely that the new government of Social Democrats and Social Liberals will engage in expansionary fiscal policy because of still scarce collections of budget revenues and due to government pledges to international institutions.

In the 1st quarter of this year, gross investment augmented by 8%. Investment in fixed capital demonstrated an increase of even 14.2%, though did not reach its levels of the 1st quarters in 1998 and 1999. In the beginning of this year, the foreign trade deficit scaled down to LTL 368 million. The improved indicator of net exports was important but not unique in determining GDP growth. ***The main characteristic of economic development in the 1st quarter of 2001 was the fact that, in addition to exports, the domestic market started to drive GDP growth as well.***

The provisional data of the 2nd quarter on the industry and foreign trade suggests that the economy is continuously taking its run and that the revised figure of quarterly GDP growth is likely to be higher than in the 1st quarter. Expanding retail trade, currently plummeting unemployment, slightly improved budget revenues and revived investment all render grounds to conclude that the Lithuanian economy is stepping into the new stage of more balanced growth that may last for quit long time.

4. Economic Activity Indices

Taking into account the increasing interest among businessmen and analysts in the monitoring and forecasting of economic processes, from now on *Lithuanian Macroeconomic Review* starts to release the Economic Activity Index VBIX R. The VBIX R is an aggregate index of the real sector (i.e. production of goods and non-financial services excluding the public sector), enabling to evaluate and forecast the development of this sector.

The VBIX R is calculated without using weights or value measures. The exclusion of value measures fully eliminates the effect of fluctuations in the price level and allows assessing the dynamics of the development of separate economic activities and the real sector as a whole in constant terms. The exclusion of weights is particularly suitable for an analysis of the economy with a distinct dominance of one or several industries (and this is the case in Lithuania). If weights are used in such a case, this may entail large deviations from the general trend of economic development, which are the result of downturn or upturn in the economic sector producing a substantial share of GDP or industrial output. In addition, the non-weighted index might be found useful as a supplementary means for commercial banks to check on the direction of credit policy or to flexibly face changes in the external environment.

The calculation of VBIX R relies on data provided by *Statistics Lithuania*. The database is comprised from the indicators of *physical* production volumes for 180 types of main goods and services and is divided into 5 groups: industry, agriculture, construction, transport, and communications. In the opening move of the estimation of VBIX R, indices of individual products measured in physical terms are calculated by comparing their monthly production volumes in each year (including 1995) with the base – the average monthly production volume in 1995. Next, the estimated individual product indices are combined into the type-of-activity (group) indices, the latter – into the aggregate (industrial, agricultural, construction, transport and communications) indices, and these, in turn, – into the VBIX R.

A data-smoothing algorithm is included in the system in order to eliminate random effects and to mitigate seasonal fluctuations. Normalised monthly indices smoothed by the centred 21-month moving average (curves "VBIX R" or "Activity index" in diagrams) are used to illustrate the economic activity of a certain sub-sector or the real sector as a whole in the medium- and long run. For the purpose of analysing production changes in the short run, actual monthly indices (curve "Actual" in diagrams) are referred to. Smoothed rather than actual indices are hinted at in the analysis of the medium- and long run, since they better reflect the trend. The increasing index of a certain type of activity implies a growth in the physical production volume of most of its components, i.e. products included in that type of activity.

An important characteristic of the system is that the indices comprising the VBIX R may be easily forecasted, i.e. the time series of all indicators being estimated can be projected and shifts in the economic activity in a short- and medium-term perspective can be predicted. Forecasts are made on the basis of data for the month under review in a certain year and the corresponding figures of the two previous years, adjusting the result by seasonality coefficients.

The VBIX R index of the real sector is a quite accurate and reliable analytic tool, since its forecasts of recent years have been close to the actual result. It is worth noting that the initial correlation-regression analysis of GDP, the real sector and the industrial activity index has evidenced a strong interdependence among these three indicators.

Table 4.1 and Diagrams 4.1–4.5 show changes in and forecasts for the economic activity of the real sector and its sub-sectors (end-of-period data). Forecasts are made for two horizons: 1) one-calendar quarter and 2) time period remaining till the end of a year (as compared to the end of the previous year).

During the 1st quarter of 2001, as compared to December of 2000, the index of industrial activity increased appreciably (see Diagram 4.1). This growth has been mostly driven by the successful operations (particularly at the close of the quarter) of oil refinement, manufacturing of motor vehicles and other transport equipment, machinery, electrical equipment and instruments, leather and textile products, basic metals and metal products, wood and wood products, rubber and plastic products. As usually, in March the mining and

Table 4.1

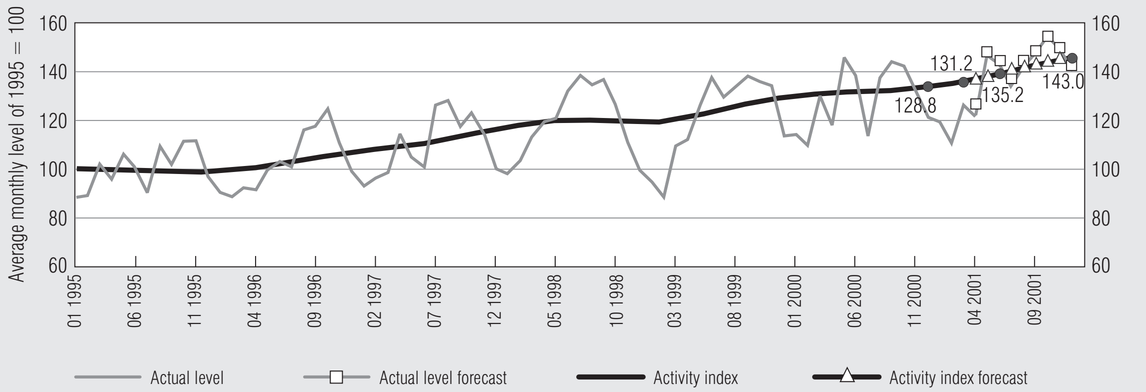
Activity Indices of the Real Sector

Real sector	Changes in the economic activity, % (March, 2001 as compared to December, 2000)	Forecasts, % (as compared to December, 2000)	
		till 06 30 2001	**till 12 31 2001**
Industry	1.9	5.0	11.0
Agriculture	–0.8	–0.3	1.7
Construction	–0.3	0.4	3.0
Transport	–2.0	–2.9	1.7
Communications*	n. d.	1.2	5.0
VBIX R	**–0.2**	**0.6**	**4.6**

* *Statistics Lithuania* has not announced yet the results of the communications sector in the 1st quarter of 2001. Therefore, the forecast is made on the basis of time series till the end of 2000.

Diagram 4.1

Index of Industrial Activity



quarrying industry enlarged its extraction output. On the contrary, a decrease in the manufacturing of chemicals and chemical products, electricity, gas and water supply has negatively affected the index development.

The activity of agriculture (see Diagram 4.2) and construction (see Diagram 4.3) has shrunk. The agricultural activity index has went down due to the continuously sinking (since the end of 1999) buying-up of livestock and poultry. The construction activity index has started to fall notably slower than earlier as a primary result of an increase in construction of new non-residential buildings, repair and restoration services. Further growth of the industry and the whole economy will lead to the larger number of construction works orders and consequently will liven up the construction sector activity. The latest results approve this presumption – in the 1st quarter of 2001, fixed capital formation increased by 14.2%. The number of granted permits for construction rose as well.

In the beginning of 2001, the transport activity index demonstrated the deepest decline among other indices of the real sector (see Diagram 4.4). This downturn has been mainly predetermined by a decrease in the following indicators: goods and passenger traffic by waterways, goods traffic by public railways, goods loaded to and unloaded from seagoing vessels and passenger traffic by trolley buses. On the other hand, in the discussed quarter of 2001, transportation by oil pipelines went up a lot and reached the highest level since the beginning of 1995. In addition, there was an increase in passenger traffic by Lithuanian airline companies. The reason for diminishing goods traffic, loading and unloading activities in the 1st quarter of this year was slower economic expansion in external markets. Besides, the comparatively high results of the corresponding quarter of 2000 constituted an unfavourable base for this year's growth. Nevertheless, the mentioned indicators have a better base to improve in the second half of this year due to the worse figures in July–December of 2000.

The forecasts for the end of 2001, as compared to December 2000, suggest that the activity indices of the real sector and its separate subsectors will show different results: the industrial

Diagram 4.2

Index of Agricultural Activity

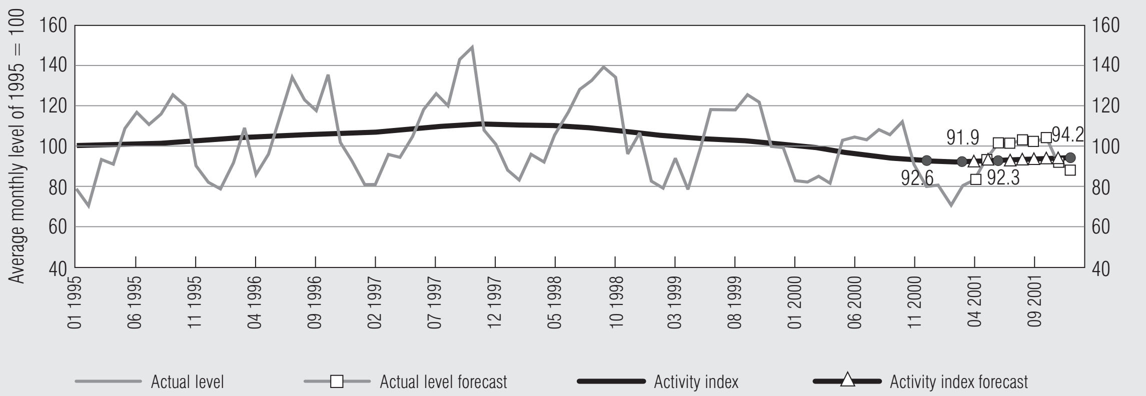


Diagram 4.3

Index of Construction Activity

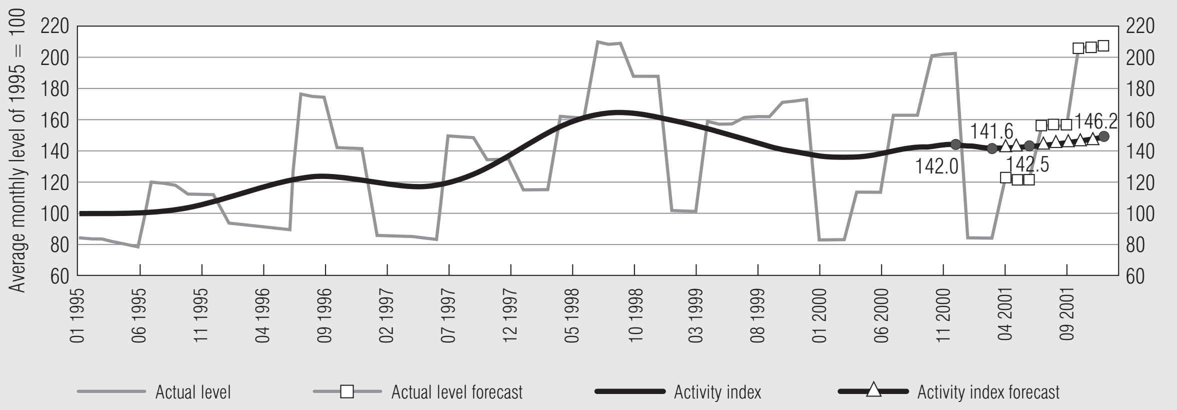


Diagram 4.4

Index of Transport Activity

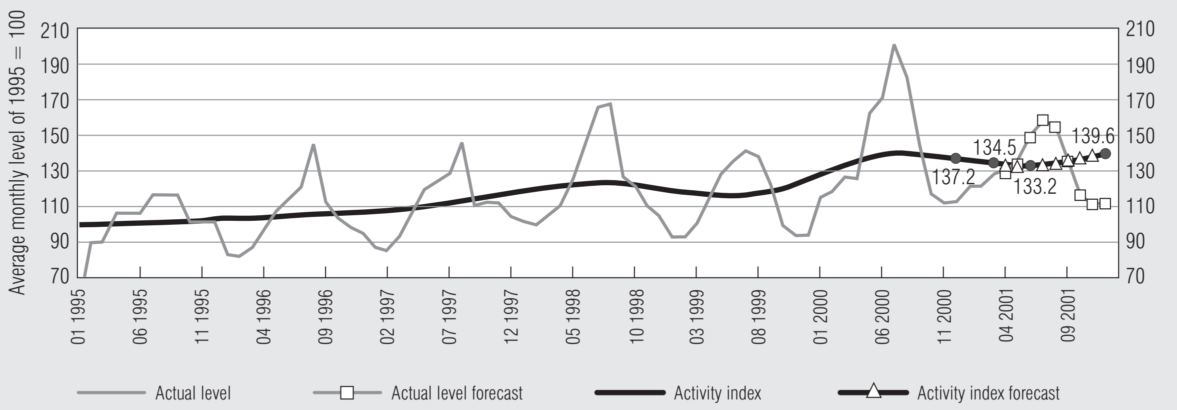
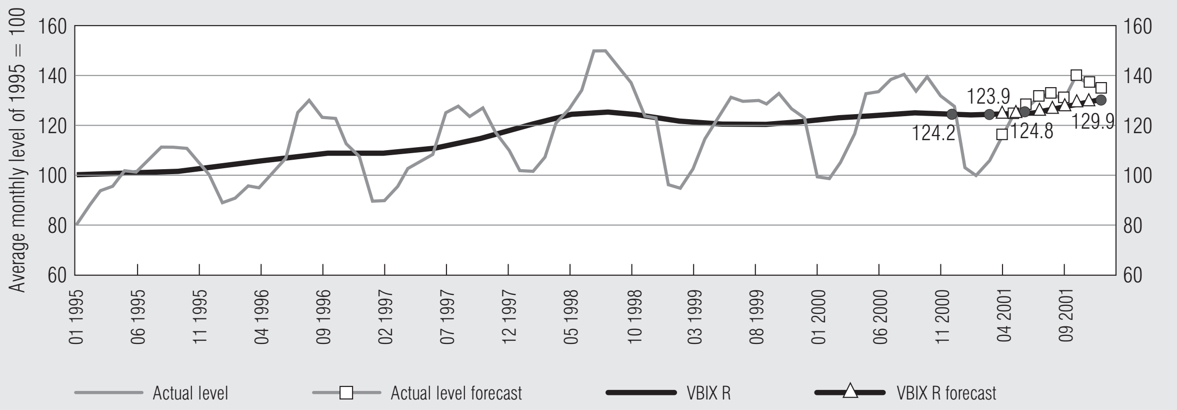


Diagram 4.5

VBIX R, Index of Real Sector's Activity



activity is expected to augment by 11%, agricultural – by 1.7%, construction – by 3.0%, transport – by 1.7%, communication – by 5.0%. The aggregate VBIX R index is predicted to increase by 4.6% (see Diagram 4.5).

5. Effects of Re-pegging the Litas to the Euro on the Lithuanian Economy

In June the *Bank of Lithuania* (BoL) announced its plan for re-anchoring the litas from the US dollar to the euro. Uncertainty about the plan and details of re-pegging the litas was dissolved, and presently businessmen are faced with the important task to analyse how this will affect their activities after February 2, 2002, what risks will arise or diminish. Obviously, outcomes of a switch in the anchor currency will be different for different economic activities, and a variety of models for adjustment will be needed.

First of all, it should be noted that ***the aim of re-anchoring the litas to the euro is not to find and establish a certain exchange rate, which is favourable for the competitiveness of exporting companies, but to ensure stable business conditions for active Lithuanian traders with the European Union.*** Hidden devaluation is possible in case a depreciation of the euro after it becomes the anchor currency of the litas is precisely determined. However, such forecasts are infeasible. Furthermore, they are not a function of state institutions.

Next, the re-pegging of the litas is not and cannot be beneficial for all businessmen; it only re-distributes the currency exchange risk among them. The implementation of this decision means that companies exporting or importing exclusively for euro will avoid the currency exchange risk. In contrast, companies that currently almost do not face the currency exchange risk, i.e. those exporting or importing for US dollars, will be mostly exposed to it. Evidently, the currency exchange risk will negligibly change and stay minimal in companies settling their imports and exports in the same currency, it does not matter whether in US dollars or in euro. On the contrary, companies exporting their outputs for euro, but importing production inputs for US dollars will be sensitive to the currency exchange risk. Such companies will suffer losses as a result of the depreciated euro both at present and in the future. Of course, the above-reiterated cases are only theoretical generalisations. In reality, each company has unique structures of currency settlements and expenditures on domestic raw materials or labour, and thus should be analysed separately.

The ***textile industry*** is one of the economic sectors that are essentially going to get rid of the currency exchange risk after the litas is re-anchored to the euro. In the 1st quarter of 2001, the share of Lithuanian origin textile products exported to the EU reached even 88% (see Diagram 5.1). This industry is highly reliable on domestic raw materials; the share of labour costs in this industry is large relative to other economic activities (see Diagram 5.5). The peg of the litas to the euro will mean that the costs of raw materials and labour are adjusted to proceeds from exports. The problems of financing these costs will be likely only in case physical volumes or prices of exports start to decline. At present, however, fluctuations in the litas and the euro exchange rate have influence on export revenues as well.

The effect of re-anchoring the litas on the ***industry of food products*** is not perfectly clear. In the 1st quarter of this year, exports constituted only about 25% of the industry's output. The share of Lithuanian origin food products exported to the EU came to 28.5% and to the CIS – 35.7%; exports to the U.S are relatively significant, too (see Diagram 5.2). The activities of the sector depend on domestic raw materials more than a majority of other economic activities. The share of labour costs in the food industry is less than in the entire manufacturing industry on the average (see Diagram 5.5). In sum, the industry of food products is not very sensitive to the currency exchange risk, and the situation is

Diagram 5.1

Exports of Lithuanian Origin Textile and Textile Products by Country Groups (LTL million)

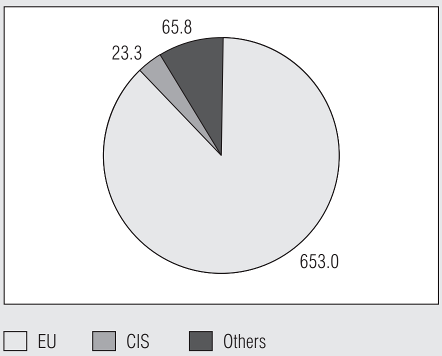


Diagram 5.2

Exports of Lithuanian Origin Food Products by Country Groups (LTL million)

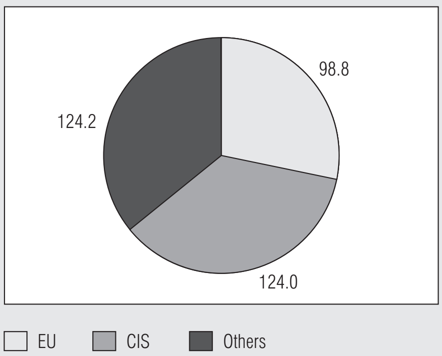


Diagram 5.3

Exports of Lithuanian Origin Mineral Products by Country Groups (LTL million)

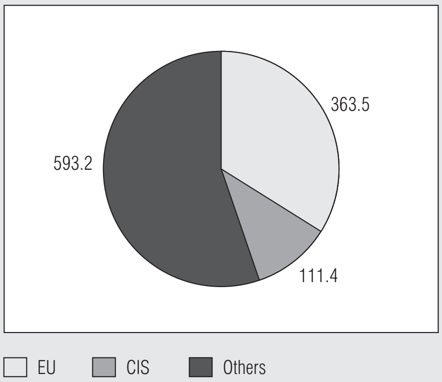
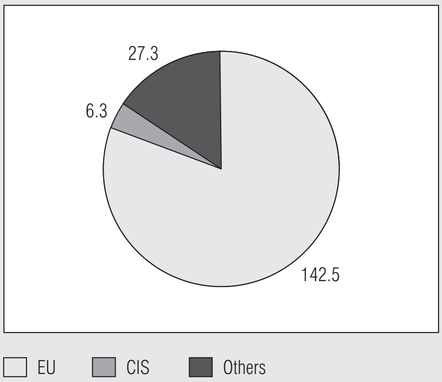


Diagram 5.4

Exports of Lithuanian Origin Furniture by Country Groups (LTL million)



not likely to drastically change after re-pegging the litas to the euro. This is assured by the primary focus of the industry on servicing the domestic market and by quite thorough export diversification.

The consequences of re-pegging the litas in the ***refined oil industry*** may be even negative. Production inputs are mainly imported from Russia and settled in US dollars. The industry almost does not make any payments in litas with the exception of paid wages, the share of which (in total production costs) is negligible (see Diagram 5.5). At the same time, the share of output sold for litas is notably larger. After the litas is no longer fixed to the US dollar, the currency exchange risk experienced by the sector is likely to go up because of income and costs inadequacy. It is worth noting that the refined oil industry sells a large share of its output abroad (see Diagram 5.3) mainly for US dollars. Nevertheless, in general, the progress prospects of the sector depend on guaranteed supply of raw materials significantly more than on the currency exchange risk.

It is barely possible that the ***energy sector*** is going to benefit from re-anchoring the litas. The sector strongly relies on raw materials imported from the East that are acquired for US dollars, and at the same time sells a significant share of its output domestically for litas. At the moment, the litas is fixed to the US dollar, and the sector does not experience any inconvenience. However, in the near future, after the litas is pegged to the euro and the LTL/US$ exchange rate starts to fluctuate, this will result in gains or losses.

The sector of ***construction*** is highly concentrated domestically, especially after the Russian crisis has shut the door for exports to the East. The sector enlarges its imports of construction materials and equipment from the EU and pays for them in euro. Therefore, after the national currency is anchored to the euro, the currency exchange risk will become less significant. Interestingly, due to the current litas peg to the US dollar and its appreciation against the euro during 1999–2001, the imports of construction goods have notably cheapened and benefited the sector.

Similar to the industry of food products, ***agriculture*** is likely to end up with no losses or gains as a result of re-pegging the litas. On the one hand, agricultural products are increasingly penetrating into the European market (for instance, the share of livestock (of Lithuanian origin) exports to the EU comes to 31.9%). On the other hand, expenditures on fuels, machinery and appliances are usually settled in US dollars (it is worth mentioning that the share of investment goods imports from the EU is increasing).

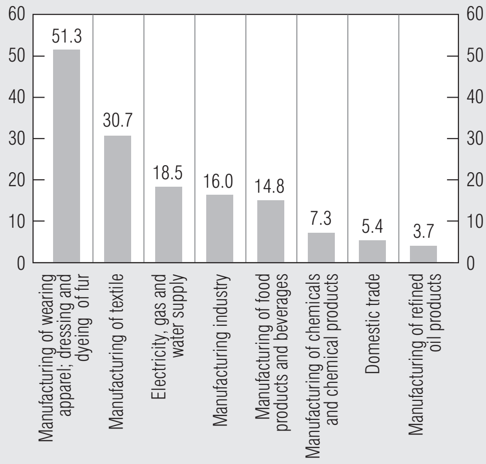
The sector of ***domestic trade*** consists of businesses selling various goods, and thus the influence of fixing the litas to the euro will be different for each of them. Domestic traders in fuels have least grounds for optimism, because, after the litas is pegged to the euro, the litas and the US dollar exchange rate will become an additional determinant of the wholesale price of oil. Although the demand for fuels is quite inelastic in regard to the price, activity planning will become more difficult. The currency exchange risk of other type traders is likely to diminish, because the share of goods imports, excluding oil, coming from the EU and other countries related to this region reaches 70%.

As it is already mentioned in this section, due to the current litas peg to the US dollar and the depreciating euro over recent years, imports have become cheaper. This has helped the sector of domestic trade to survive the difficult times of low purchasing power of households and businesses and thus stagnating domestic demand.

Concerns about devaluation of the litas during a switch to another anchor currency have notably hushed. Even analysts, who are sceptical about the Lithuanian financial situation, agree that the litas devaluation would resolve in more costs than benefits. The latter holds true because of Lithuanian imports from Russia and other CIS countries (oil, gas and other irreplaceable raw materials) that are inflexible in demand. If the litas

Diagram 5.5

Labour Costs of Various Economic Activities (as a % of total production costs)



were devalued, imports from the East would become more expensive and would outweigh the initial positive effect of devaluation on the competitiveness of Lithuanian goods. As a result of the devalued litas, domestic wages and thus total production costs should become lower in terms of foreign currencies. However, the share of labour costs is insignificant in a majority of Lithuanian sectors (see Diagram 5.5), and changes in wages can hardly have any notable influence on total production costs. Moreover, the devalued litas can severely hit the stability of financial markets and the investment process.

The textile industry is one of not many sectors that theoretically can benefit from devaluation. In contrast to other economic activities, this industry is labour-intensive (see Diagram 5.5) and strongly relies on raw materials of domestic origin. A larger share of its output is exported. Nonetheless, it would be a heavy mistake to access the progress prospects of any industry in isolation with the general situation in the economy. The policy of the weak litas would definitely impede the general economic development of Lithuania.

The direct effect of the devalued litas on the industry of food products is controversial. On the one hand, the sector can be favoured by relatively cheaper prices of local raw materials that are intensively used in production processes. On the other hand, exports by the industry are scarce, and thus the devalued national currency is pointless in this sense.

The devaluation of the litas would be painful for the refined oil industry, and would cause additional financial problems for *Mažeikių nafta* (*Mažeikiai Oil Refinery*). The import of raw oil would automatically go up in price, but it would be nearly impossible to raise the prices of refined oil products sold domestically (by the same amount) due to decreased real wages and internal consumption. Furthermore, it would be just so difficult to put the increased costs of depreciation (as an outcome of relatively more expensive equipment imports) on the prices of refined oil products. Last but not least, it would become more complex to service foreign currency loans acquired by the refinery. The outcomes of the devalued litas would be similar for the energy sector.

Domestic trade would realise costs rather benefits of devaluation. Imports would become more expensive, and at the same time the plummeted purchasing power of households would press for cuts in prices of traded goods. The decreased trade turnover and bankruptcies of small- and medium-sized sellers are obvious consequences. Another sector's argument against devaluation is the relatively small share of labour costs and thus its limited ability to withstand the discussed business difficulties with the help of these costs.

6. Foreign Trade

The boom of exports that started last year slightly subsided in the 1st quarter of this year. On the contrary, imports rose more intensively than a year ago. ***In the beginning of this year exports and imports increased at a similar pace, while last year the former grew notably faster.*** In the 1st quarter of 2001, exports came to LTL 4.29 billion, and imports – LTL 5.69 billion, i.e. demonstrated an increase of 15.0% and 14.2% over a year, respectively. The foreign trade deficit went up from LTL 1.25 billion to LTL 1.40 billion (see Diagram 6.1).

Although this section gives data on foreign trade as released by *Statistics Lithuania* (exports at f.o.b. prices and imports at c.i.f. prices), for analytic purposes, all balances are calculated on the basis of exports and imports at the same f.o.b. prices and are showed as a % of total turnover. Imports at f.o.b. prices are attained from imports at c.i.f. prices by reducing the latter by 5% (as suggested by the average calculations of the *Bank of Lithuania*). According to this method, in the 1st quarter of 2001, the balance of foreign trade accounted for −11.5% of the total turnover and was the smallest as compared to any quarter of 1997–2000 (see Appendix, Table B.1).

In 2000, exports showed an increase of 26.8% over a year. This year their growth rates plunged almost twice. Nevertheless, it should not be concluded that the country is on the brink of exhausting its potential capabilities. In 2000, the export of mineral products (MP) grew by 78.8% as a result of hopped off prices of raw oil (at constant prices, the export of MP rose by only 10.8%) and contributed to the general increase in exports a lot. In the 1st quarter of 2001, the export of MP demonstrated an increase of 21.8% over a year (at constant prices, 26.9%, see Diagram 6.2), which was the primary outcome of improved supply of raw materials to *Mažeikių nafta* from the East. Since *Mažeikių nafta* has signed an agreement with Russian *Jukos* on long-term supply of oil, it is likely that the export of MP will rise in the future as well.

Rapidly expanding extraction of oil domestically and signed agreements on electricity exports to Belarus and Kaliningrad may serve as additional stimuli for growth

Diagram 6.1

Exports, Imports and Foreign Trade Balance (LTL million)

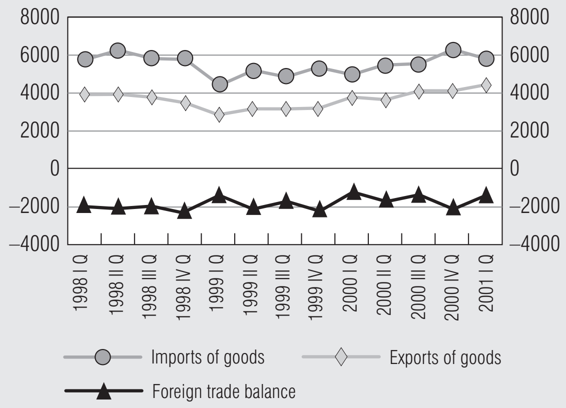
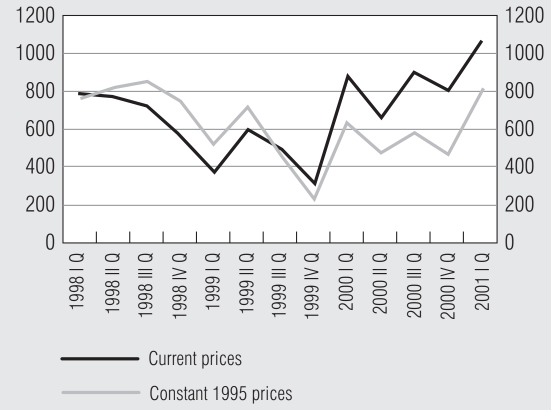


Diagram 6.2

Exports of Mineral Products (LTL million)



in the MP export (electricity is one of the MP). In the 1st quarter of 2001, the export of electricity grew by 27.1%, but constituted an insignificant share (approximately 1%) of all exports.

In the discussed period of this year, the exports of other goods (i.e. excluding MP) demonstrated an increase of 12.9% over a year, while the respective figure for the whole previous year was 17.6%. In the 1st quarter of 2001, the exports of Lithuanian origin goods grew by 17.2% as compared to the 1st quarter of 2000 and by 27.7% as compared to the 1st quarter of 1998. ***Lately, the exports of Lithuanian origin goods have been rising notably faster than re-exports and obviously have overcome the levels that existed before the Russian crisis.***

In the 1st quarter of 2001, the volume of re-exports rose by 5.8% as compared to a year ago and decreased by even 31.8% as compared to the 1st quarter of 1998. Last year the share of re-exports still constituted 1/5 of total exports.

If the euro did not tumble into a pit and stayed as strong as it was at least at the end of 2000, the results of export growth for the beginning of 2001 would be better. Despite the traditionally unfavourable exchange rate of the litas and the euro, in the 1st quarter of 2001, Lithuanian exports to the European Union (EU) were more dynamic than on the average. They showed an increase of 27.7%; exports of goods produced in Lithuania – even 34.8%. This growth was the primary result of exported MP that hiked almost 9 times (the share of MP went from 2.5% a year ago to 16.9% of total exports to the EU). Exports without MP went up by only 8.8% and exports of Lithuanian origin goods without MP rose by 13.0%. The volume of agricultural and food products exported to the EU climbed by even 40.4%.

The rapidly growing export of food products has solved the problem of their local oversupply. The buying-up prices of agricultural products have started to point upward, and farmers have become somewhat more optimistic about the future.

It should be noted, however, that food products amounted to only insignificant 5.6% of Lithuanian exports to the EU. Textile products were the main exports that constituted even 31.4%. MP were in second place, and machinery and appliances (with a share of 9.3%) in third. Wood and wood products, furniture and transport equipment had notable export shares as well.

Germany, Great Britain, Denmark and Sweden were the main European markets of Lithuanian exports. In the 1st quarter of this year, Germany was second largest export market after Latvia. The share of exports to Germany came to 14.8% and excluding MP – even 19.6% (by this indicator, Germany took first place). Lithuanian exports to this country revived and demonstrated an increase of 21.4%. Exports mainly consisted of textile products, chemical products, wood products and furniture with the respective shares of 29.4%, 17.4%, 8.9% and 8.8%. It is worth mentioning that in 2000 Germany enlarged its investment in the Lithuanian textile industry by more than 1/5 and took the lead by FDI in this sector. Therefore, not accidentally the export of textile products to Germany grew by 35.1% as compared to a year ago. The export of chemical products rose at an even higher pace, i.e. 57.9%.

Recently, Lithuanian exports to Great Britain have been robustly increasing. In the 1st quarter of this year, they showed an increase of 3.2 times and constituted 12.5% of total exports. The volume of oil products exported to Great Britain rose even 13 times. The export share of MP came to 65%. An increase in exports of other goods was significant too and reached 31.7%. Latvians have surpassed Lithuanians by penetrating into the market of Great Britain, which has already become one of the most important trade partners (of Latvia).

In the 1st quarter of 2001, Lithuanian exports to Scandinavian countries slowed down after a quite long break. Exports to Denmark went up by 5.7% and to Sweden – by 7.8%. Exports to both Denmark and Sweden constituted 9% of total exports, and this is related to active investment by these European countries in Lithuania (almost 1/3 of FDI in the Lithuanian manufacturing industry is made by Denmark and Sweden). Exports to Finland and Norway showed an increase of more than on the average, i.e. of about 20%.

With the rapidly growing economy of CIS countries, Lithuanian businessmen have been expanding their exports to this region, too. In the 1st quarter of 2001, exports to the CIS rose by 25.5% as compared to the same period of last year (to Russia alone, by even 41.4%). The share of exports that went to the CIS constituted 16.4%, to Russia – 7.5%. Despite of this fact, it would be premature to conclude that Lithuanian trade with Russia has revived. The volume of Lithuanian origin exports to the CIS grew by only 12.3%, while to Russia even decreased by 3.0% (for instance, the export of Lithuanian food products to Russia plummeted by 17.8%). Rising re-exports were the main determinant of export growth. Unfortunately, it is quite problematic to access exact origin of goods, and therefore such information collected and released by customhouses is hardly reliable. After the decline in 2000, in the discussed quarter of this year, exports to Belarus recovered and even outstripped exports to Ukraine by their importance.

Exports to the CIS mainly consisted of food products, transport equipment, mineral products, and machines and appliances with the respective shares of 22.1%, 19.8%, 15.9% and 12.5%.

During recent years exports to CEFTA countries have been growing very dynamically, but in the 1st quarter of 2001 demonstrated an increase of only 5.4% (without MP, even a decrease of 11.1%). The share of exports to Poland, main foreign trade partner of Lithuania in Central and Eastern Europe, exceeded 80% (of exports to CEFTA countries). The volume of exports to this country rose by 29.7% (without MP, by 7.6%). MP constituted almost half of Lithuanian exports to CEFTA countries and to Poland alone.

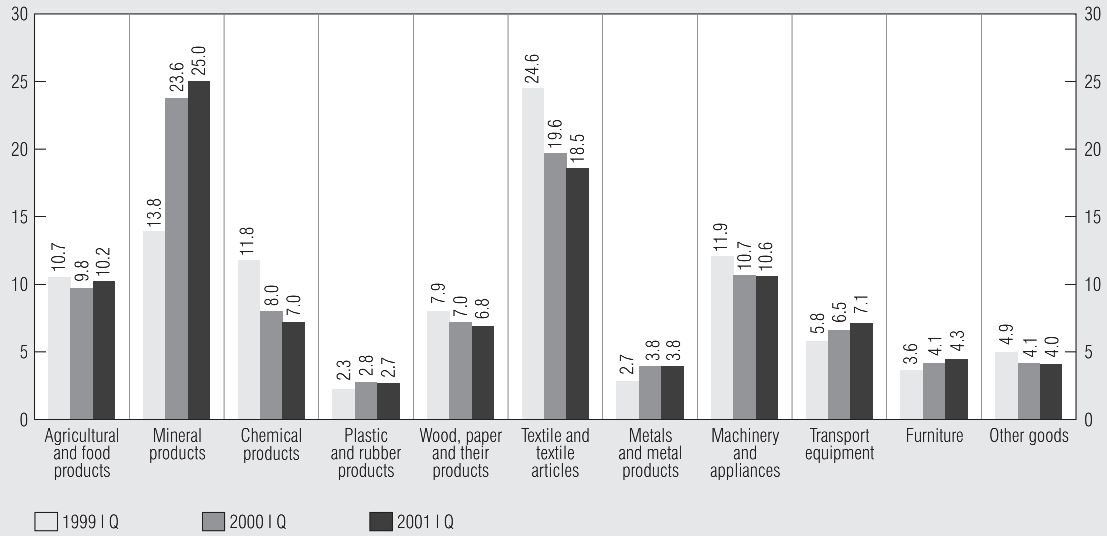
Meanwhile Latvia continues to be the largest market of Lithuanian exports. In the 1st quarter of 2001, the share of total exports that went to Latvia accounted for 15.2% (excluding MP, only 7.4%; i.e. lower than the shares of exports to Germany and to Russia). As compared to the same period of 2000, the volume of exports to Latvia did not go up, and the export of MP demonstrated a decline of 8.4%.

The vigorous growth rates of exports to the USA during late years subsided to a quite moderate increase of 14.9% in the 1st quarter of 2001. Nevertheless, exports of certain goods kept robustly expanding. For instance, the export of plastic and rubber products almost doubled as compared to the same period of last year. The export of machines and appliances augmented even more, 3 times. The export of furniture rose 2.3 times. The shares of the latter two were modest, 7.6% and 2.8% of total exports to the USA, respectively. The export of textile products plummeted by 37.9% as compared to a year ago.

Table B.1 in Appendix shows the structure of foreign trade by countries and by product groups. The structure of imports demonstrated no significant changes as compared to the corresponding period of the previous year. In the 1st quarter of 2001, the share of imports from the EU amounted to 44.4%, from the CIS – 32.6% and from CEFTA countries – 8.6% of all Lithuanian imports. Leaders of import markets of the past preserved their top positions. In the said period of this year, imports from Russia constituted 29.1% and from Germany – 16.7% of all imports. The share of imports from Poland reached 6.0%, and took third place. In contrast, imports from Great Britain plunged almost twice.

Diagram 6.3

Export Structure by Commodity Groups (%)



The balance of Lithuanian trade with the EU greatly improved from –12.6% to –5.6% of the total turnover. The balances of Lithuanian trade with Latvia, Great Britain, Ukraine and Belarus were positive. For the first time since 1996, the balance of trade with Estonia turned to be positive, too. Exports to and imports from Denmark, Sweden and France nearly balanced out. Despite of larger exports to Germany, the balance of trade with this country worsened and reached –17.3%. Lithuanian trade with Russia was in the largest deficit. Nevertheless, it shrank from –70.2% to –65.9% per annum. This deficit is of structural origin, because Russia is at the moment and will be at least in the nearest future the important source of raw materials for Lithuania.

Diagram 6.3 shows the structure of exports by commodity groups in the 1st quarters of 1999, 2000 and 2001.

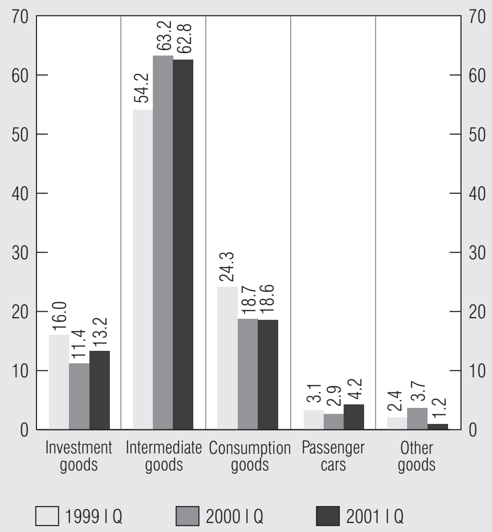
In the 1st quarter of this year, the shares of MP and food products went up to 25% and slightly more than 10%, respectively. In contrast, the shares of textile and chemical products plunged to 18.5% and 7.0%, respectively.

Although exports of some commodity groups (MP, food products, transport equipment and furniture) demonstrated annual increases of 20% and more, a majority of trade balances ended up negative. The exception was furniture, textile and leather articles, wood and wood products. The balances of foreign trade in food products and MP improved, though were negative, i.e. –8.7% and –12.4% respectively (see Appendix, Table B.2).

Diagram 6.4 gives the structure of imports by economic categories of goods in the 1st quarters of 1999, 2000 and 2001. The import share of investment goods notably turned up. For the first time after the Russian crisis, the import of investment goods rose by 18% in the 4th quarter of last year. In the 1st quarter of this year, the increase reached 32.2%. These figures are closely correlated with the indicators of capital investment. The long-lasting decrease in capital investment was terminated at the close of last year. In the beginning of this year, the growth rates of capital investment even gained some speed.

Diagram 6.4

Import Structure by Economic Categories of Goods (%)



The data on foreign trade for April and May was encouraging and put grounds to expect good results for the 2nd quarter.

7. Balance of Payments

The positive tendencies of the balance of payments that emerged in the beginning of 2000 stepped into this year as well. In the 1st quarter, the current account deficit (CAD) showed an insignificant increase of 1.4% over a year or went up from LTL 573.4 million to LTL 581.5 million. Since GDP was augmenting at a higher pace, the CAD to GDP ratio shrank from 5.7% to 5.4% (see Diagram 7.1).

The situation is indeed auspicious, especially having in mind that in the beginning of this year the external environment was notably worse than last year. The economies of almost all trade partners of Lithuania have slackened with the exception of Latvia. In general, the climate of the world economy has cooled off (see **External Markets**). In the beginning of 2001, the litas and the euro exchange rate stayed nearly the same as a year ago and continued to hinder Lithuanian exports to the European Union (EU). Nevertheless, businessmen proved to be able to withstand negative developments of the economic conjuncture. This leads to the conclusion that exporting companies did not waste their time in 1999–2000, and renovated their production technologies, minimised production costs.

Although the government cut its spending again, imports grew faster than last year. Private consumption and gross investment pointed upward and contributed to import growth. Increased gross investment drove the growth of investment goods imports. Section **Foreign Trade** features a detailed analysis of imports and exports.

The ***balance of services*** improved as a result of lower imports (of services) rather than higher exports. Nevertheless, the exports of certain non-essential services showed quite amazing annual growth. For instance, the exports of financial and trading intermediation services hiked a couple of times. At the same time, the export of transport services, constituting more than half of total exported services, demonstrated an increase of only 2.2%. The export of travel services, constituting 28.1% of all exported services, even dropped by 3.9%. The export of construction services continued to slip down and reached a symbolic value of LTL 6.7 million.

In the 1st quarter of 2001, the imports of services showed a decline of 12.3%, mainly due to the lower imports of travel, trading intermediation, construction and other services.

Diagram 7.1

Current Account Deficit, % of GDP

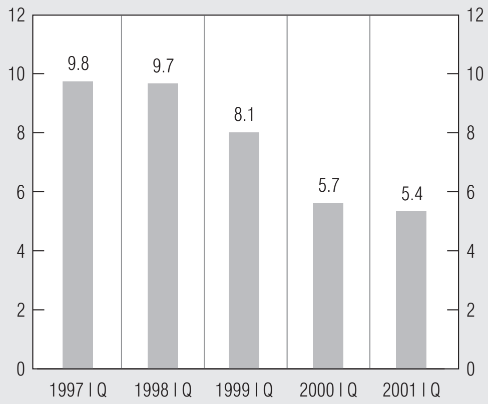
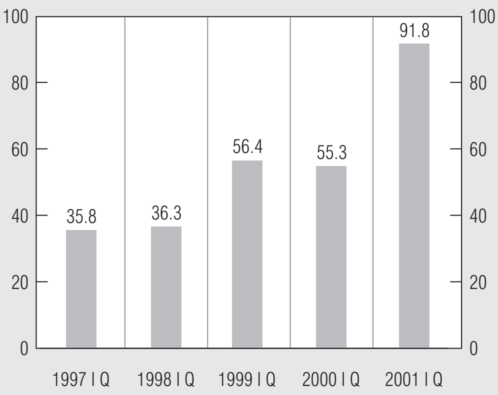


Diagram 7.2

Foreign Direct Investment, % of CAD



As in previous years, the ***balance of income*** was in deficit, but this time it was large in particular and amounted to LTL –421.4 million. As compared to the 1st quarter of 2000, the deficit rose by 37.5% essentially on the back of higher re-investment by foreigners that showed an increase of LTL 182.7 million. Interestingly, in the discussed period non-residential re-investment was the main determinant of increased direct investment in the country. More than half of total re-investment went into the sectors of communications and banking.

These facts suggest that ***foreign businessmen operating in Lithuania are more optimistic about the progress prospects of the country than those who are not familiar with the Lithuanian market and are cautious about it (this is well reflected by the absence of "green field" investment).*** Nevertheless, in quarters to come, privatisation of remaining state wealth, not re-investment, will become the dominant source of foreign direct investment (FDI). Income earned by Lithuanians abroad continued to rise in the 1st quarter of 2001 and implied that the number of legal Lithuanian workers in foreign countries has been growing.

In the 1st quarter of this year, the net capital flow of the ***financial account*** robustly increased as compared to a year ago. Investment by Lithuanians abroad climbed by more than LTL 1 billion or 2.5 times per annum due to the following. First, some of government proceeds from the sale of eurobonds were invested in foreign countries. Next, commercial banks and other economic players increased their accounts in foreign banks. Last but not least, accounts payable by foreigners for acquired Lithuanian goods and services showed an increase of LTL 160.7 million, while in the 1st quarter of 2000 the respective figure was negative and came to LTL –131.7 million.

In the 1st quarter of 2001, the flow of gross foreign investment in Lithuania came to LTL 1.99 billion and increased by LTL 676.1 million or 51.5% as compared to a year ago. Foreign capital mainly flew in the form of portfolio investment (LTL 881.1 million), the largest share of which went to the government as proceeds from sold eurobonds (LTL 732.5 million). FDI was another source of foreign investment in Lithuania and came to LTL 533.9 million. As it is already mentioned above, reinvestment was the main driving force of FDI in the discussed period. The government received only LTL 4.2 million from the sales of state-owned assets for foreigners.

In the 1st quarter of this year, the FDI to CAD ratio reached its record-breaking highs since mid-1998, which was when the privatisation of *Lietuvos telekomas* ***took place.*** Diagram 7.2 shows the dynamics of the said ratio in the 1st quarters of 1997–2001.

Since the close of 1999, net foreign loans granted to the economic sectors of Lithuania continued to be negative, meaning more loans repaid than acquired. The figure for the 1st quarter of 2001 was not the exception and summed LTL –42.2 million (in the 1st quarter of 2000, LTL –111.4 million). This year the negative indicator of net foreign loans notably decreased and may even settle down to normal track, i.e. positive net borrowing from abroad to meet the needs of the growing economy.

In the 1st quarter of 2001, ***official international reserves*** showed a decrease of LTL 227.6 million. Net official international reserves (i.e. excluding gold), as calculated in terms of imports of goods and services per month, shrank from 2.7-month imports at the end of last year to 2.5-month imports at the end of the 1st quarter of this year. The decreased indicator should not be interpreted as an economic threat, because the current financial situation of the country is quite good and the probability of speculative attacks against the national currency is minimal.

8. Unemployment

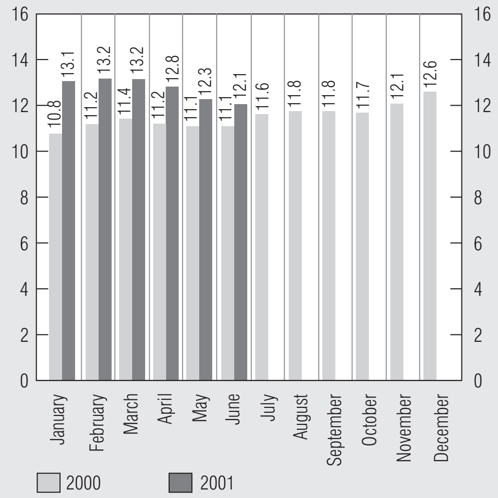
During late months the situation in the labour market slightly improved, the unemployment rate decreased.

This is a usual phenomenon predetermined by seasonal fluctuations, larger supply of temporary jobs and more actively organised of public works.

Nevertheless, the reasons stated above fall short in explaining the decrease in unemployment. Certain positive shifts that became obvious over recent months are exclusive characteristics of this year. From January 1 till July 1, 2001 the unemployment rate declined by 0.5 percentage points (p.p.), though demonstrated an increase of 1 p.p. over July 1, 2000. In the first half of last year unemployment did not stabilise; even worse, it notably augmented. ***Essentially, a radical breakthrough occurred in April–June of 2001, when unemployment plummeted from the record high level of 13.2% to 12.1%*** (see 8.1 diagram).

Diagram 8.1

Unemployment Rate (end-of-period, %)



The relatively high demand for labour was one of the main reasons for lower unemployment. In June, more than 14 thousand free jobs were offered in territorial labour exchange agencies. More than 70% of these jobs were for permanent employment. In comparison with the same period of last year, the number of offered jobs grew by more than 40%. In the period lasting from the start of the year, the number of permanent job offers reached 41.7 thousand and showed an increase of 10.4 thousand over the same period of 2000.

According to the forecasts of *Labour Exchange*, this year the difference between newly created and liquidated jobs will continue to be negative. The number of new jobs is expected to come to 19 thousand, and the number of liquidated jobs – to 27 thousand. The positive difference between newly established and liquidated jobs exists in the private service sector as well as in small- and medium-sized enterprises. The latter have already demonstrated their vital capacity in job creation, whereas large businesses are focused on economies of scale and labour efficient technologies.

Table 8.1 suggests that from 1999 to 2001 the average number of workers diminished in all economic activities with the exception of public administration and defence, compulsory social insurance and education. Jobholders in agriculture went down in number particularly drastically from 323.8 thousand in the 1st quarter of 1999 to 280.5 thousand in the 1st quarter of this year. The number of the employed in manufacturing and domestic trade fell by less than on the average; therefore,

Table 8.1

Average Number of the Employed

	1999 IQ		2000 IQ		2001 IQ	
	Thousand	%	Thousand	%	Thousand	%
Total	**1,650.2**	**100.0**	**1,602.6**	**100.0**	**1,514.6**	**100.0**
Agriculture, hunting and forestry	323.8	19.6	310.2	19.4	280.5	18.5
Mining industry	3.4	0.2	3.4	0.2	3.1	0.2
Manufacturing industry	284.0	17.2	284.0	17.7	273.7	18.1
Electricity, gas and water supply	37.8	2.3	37.5	2.3	34.5	2.3
Construction	109.3	6.6	97.7	6.1	90.9	6.0
Domestic trade	245.3	14.9	240.5	15.0	230.4	15.2
Hotels and restaurants	27.0	1.6	23.1	1.4	25.3	1.7
Transport, storage and communications	105.1	6.4	103.4	6.5	90.8	6.0
Financial intermediation	16.5	1.0	16.0	1.0	14.6	1.0
Real estate, renting; Other business activities	55.7	3.4	52.8	3.3	45.7	3.0
Public administration and defence; Compulsory social insurance	70.5	4.3	70.6	4.4	70.6	4.6
Education	155.3	9.4	158.4	9.9	160.1	10.6
Health and social works	112.5	6.8	112.8	7.0	104.2	6.9
Other business activities	104.0	6.3	92.2	5.8	90.2	5.9

their share in the discussed period slightly enlarged. ***The number of jobholders in the manufacturing industry almost attained the number of the employed in agriculture and evidenced essential restructuring of the economy.***

The previous issue of *Lithuanian Macroeconomic Review* emphasised the problem of hidden employment. Recent special inspections suggest that construction companies have the largest number of illegal employees in Lithuania. From the beginning of 2001, 198 people were found working illegally or without job contracts; financial reports show that labour relations with 232 employees were recorded incorrectly or not recorded at all.

9. Price Indices

The dynamics of the price level this year differs from last year at least in two respects. First, monthly inflation fluctuations are not the same. Second, prices of certain commodity groups move in the opposite direction. ***It is hardly possible that in 2001 prices will accelerate at a pace, which is significantly higher than in 2000; nevertheless, it will exceed the last year's growth rate to a certain extent.*** In the period from January to June of the previous year, deflation was recorded in two months (March and May), and in one month the price level stayed constant. In contrast, in the respective period of this year, the CPI (Consumer Price Index) increased each month with the exception of January (see Diagram 9.1).

In June of this year, annual inflation (June of 2001, as compared to June of 2000) was 1.5%, while the corresponding figure of last year (June of 2000, as compared to June of 1999) came to only 1.3%. The CPI rose mainly due to food products and non-alcoholic beverages going up in price. Food products and non-alcoholic beverages constitute a share of almost 37% in the CPI basket of goods and services. The prices of these commodities accelerated by 4.5%, while in June 2000, as compared to June 1999, they plummeted by 1.9% (see Di-

Diagram 9.1

Monthly CPI Changes in 2000–2001 (%)

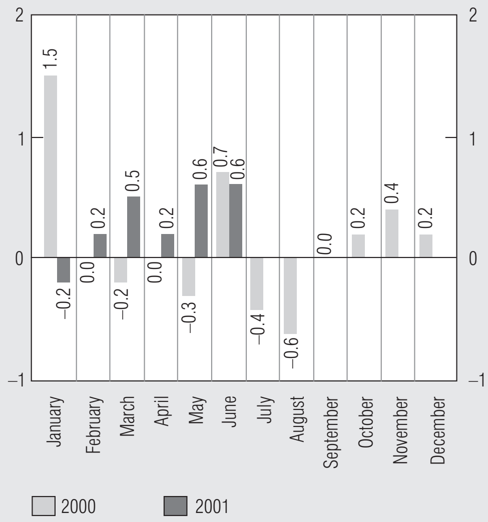


Diagram 9.2

Changes in Consumer Prices at the End of the First Halves of 2000 and 2001 (compared to the same period a year ago, %)

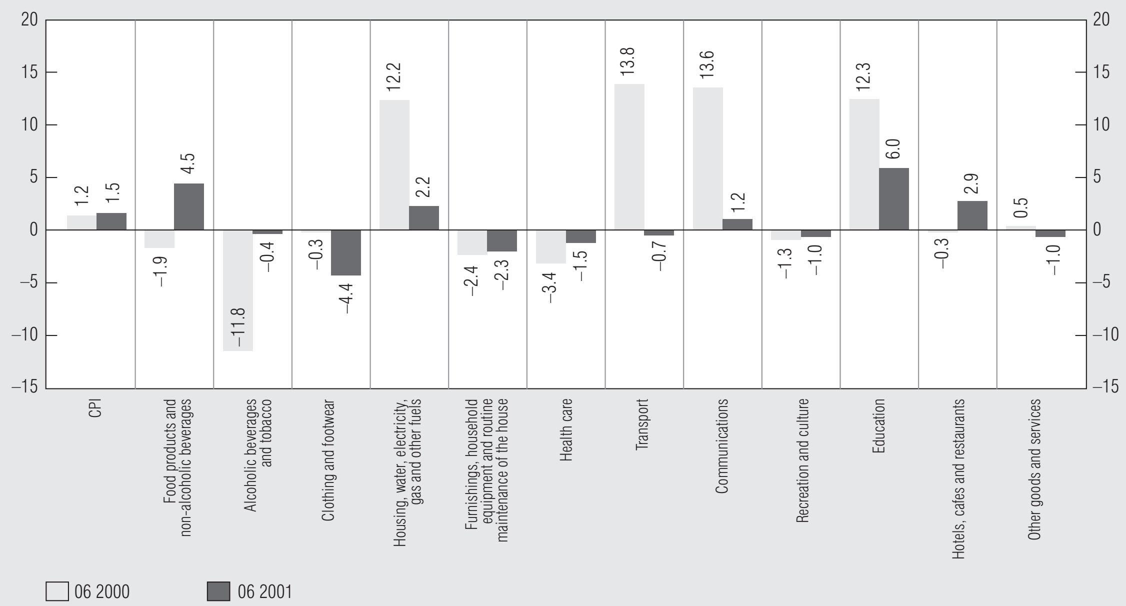
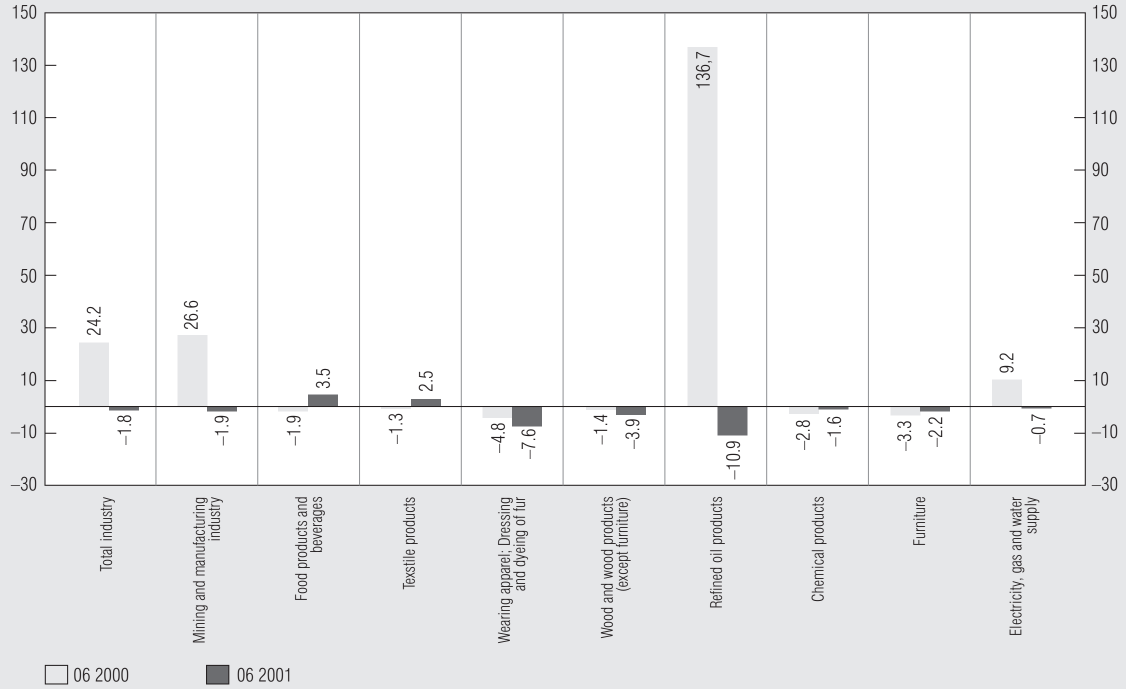


Diagram 9.3

Changes in Producer Prices at the End of the First Halves of 2000 and 2001 (compared to the same period a year ago, %)



agram 9.2). The increase in the prices of food products and non-alcoholic beverages over the discussed period was determined by both relatively insufficient supply of meat and milk products and recovering aggregate demand in the domestic market.

In June 2001, the PPI (Producer Price Index) of the entire industry, including the energy sector, showed a decline of 1.8% over a year. In contrast, in June 2000, as compared to June 1999, the figure demonstrated a vigorous increase of 24.2% (see Diagram 9.3) primarily due to skyrocketed prices of oil in the world during 1999–2000. Lately, the oil prices decelerated, and the PPI stopped to increase and even started to plunge. Prices of other commodity groups were quite constant and did not have any significant influence for changes in the PPI.

In May 2001, as compared to the corresponding month of 2000, prices of construction scaled down by 1.1% (the adequate figure in May 2000 was a decline of 0.2%).

10. Earnings and Household Income

It would be premature to conclude that positive developments have emerged in the labour market. The dynamics of earnings does not let concluding this as well. In the 1st quarter of 2001, as compared to the 4th quarter of 2000, average earnings before taxes decreased by 3.0% (see Table 10.1). It is worth mentioning, however, that the results of these two quarters are not perfectly compatible with each other due to seasonal fluctuations, i.e. payments of Christmas bonuses and other premiums in the wake of a New Year. This explains the declines in average earnings in the beginning of both 1999 and 2000, while at the start of 1998 the said indicator was constant.

Data on average earnings for a certain quarter is better compatible with the respective figure a year ago. In the 1st quarter of this year, average earnings rose by 1.2% as compared to the 1st quarter of 2000. Similarly, in the 1st quarter of 2000, the indicator showed an increase of 1.0% over a year. ***The turned down level of unemployment and the improved financial situation of companies should somewhat benefit the employed in quarters to come, i.e. wages are expected to grow at a higher pace.*** On the other hand, the need to minimise production costs hinders an increase in average earnings in a majority of manufacturing industries and other economic activities focusing on exports. Such need is the outcome of the strong litas relative to the euro and the quite sharply slowing down economy of the EU, main foreign trade partner of Lithuania.

Data on wages earned in various economic sectors reflect their structural changes and the current situation quite well and allows concluding whether a certain sector is in a relative boom or slump (see Table 10.1).

Usually, wages rise at a pace, which is higher than the average, in these economic sectors that are char-

Table 10.1

Dynamics of Earnings* by Economic Sectors in the 1st Quarters of 1997–2001 and in the 4th Quarter of 2000 (LTL)

Economic sectors	1997 IQ	1998 IQ	1999 IQ	2000 IQ	2000 IVQ	2001 IQ
Total in the economy	**713.4**	**916.7**	**1,018.1**	**1,028.5**	**1,073.2**	**1,041.1**
Agriculture	414.7	546.5	555.6	680.9	711.4	734.2
Mining industry	755.4	999.6	1,048.6	1,209.9	1,270.2	1,389.7
Manufacturing industry	771.8	909.7	986.2	1,007.9	1,063.4	1,036.3
Electricity, gas and water supply	1,165.2	1,289.7	1,369.8	1,357.3	1,445.6	1,408.1
Construction	769.8	988.2	938.8	897.2	974.8	878.4
Domestic trade	592.3	829.0	891.7	911.4	970.4	1,017.7
Hotels and restaurants	479.6	694.3	685.8	731.2	718.8	702.9
Transport and storage	839.2	1,010.6	1,046.0	1,034.4	1,069.6	1,102.2
Post and communications	884.8	1,299.0	1,318.1	1,401.0	1,457.5	1,446.4
Financial intermediation	1,595.0	1,724.4	2,074.4	2,002.4	2,095.9	2,135.0
Real estate, renting; Other business activities	748.2	1,016.4	1,249.8	1,320.2	1,309.9	1,053.4
Public administration and defence	1,003.8	1,363.7	1,548.2	1,506.6	1,581.7	1,495.6
Education	597.6	809.2	1,013.1	938.7	971.4	926.4
Health works	547.4	731.8	857.6	830.7	863.6	831.0

* Average earnings before taxes excluding individual enterprises (entrepreneurs)

Table 10.2

Average Disposable Income (LTL)

	2000 IQ			2001 IQ		
	Total	City	Province	Total	City	Province
Disposable income	**398.1**	**438.2**	**313.5**	**389.0**	**431.9**	**269.9**
Income from employment	201.5	254.3	89.8	199.7	251.3	88.6
Income from self-employment	49.4	28.6	93.5	48.2	31.3	84.3
Retirement pension	60.8	62.2	57.9	57.2	55.8	60.2
Unemployment benefits	1.4	1.7	0.8	2.0	2.5	1.2
Other pensions, benefits	38.9	36.0	45.2	43.8	44.9	41.4
Other income	46.1	55.4	26.3	38.2	46.0	21.2
Disposable income in cash	**330.5**	**389.4**	**206.0**	**329.1**	**388.7**	**201.0**
Non-cash disposable income	**67.6**	**48.8**	**107.5**	**59.9**	**43.2**	**95.9**

acterised by general indicators (output, exports, profitability and alike) exceeding their respective averages as well. Theoretically, an increase in earnings in these economic sectors should be constrained by the influx of workers from contracting economic activities. In the Lithuanian case, this comes true only partially because of not sufficiently flexible qualification and territorial labour mobility.

In 1997–2000, wages in the mining industry, the development of which was positively evaluated in the previous issue of *Lithuanian Macroeconomic Review*, rose in particular. Average earnings before taxes almost doubled. Similar wage growth rates were recorded in the sector of domestic trade, which is going through the intensive process of modernisation and investment. Not accidentally, last year capital investment in domestic trade demonstrated an increase, while the respective figure for the whole economy showed a decline. Interestingly, the most significant increase in the level of earnings in the sector of post and communications was recorded in mid-1998, i.e. before the privatisation of *Lietuvos telekomas*. Henceforth, the growth rates of this sector's earnings slackened, but remained stable.

In the reviewed period, average earnings in the sector of education turned up almost 1.6 times with the highest hikes in 1997–1998, when the government notably raised salaries for teachers. The same held true in the sector of health works.

From the 1st quarter of 1997 to the 1st quarter of 2001, average earnings in the construction sector rose by only 14%. After the Russian financial collapse, the Lithuanian construction business found itself in a cleft stick. Thus, it is not surprising that from 1998 up until now wages even shrank in absolute terms. Many dismissed builders tried to overcome these difficulties by engaging in illegal construction activities, performing random or seasonal works.

In the discussed period, average earnings in the sector of financial intermediation were the highest, though increased slower than in the economy on the average. In the banking sector, as a result of a couple of mergers and bankruptcies, the supply of labour started to exceed the demand. This situation is expected to become even more obvious after the privatisation and restructuring of *Lietuvos taupomasis bankas* (*Lithuanian Savings Bank*).

Rising wages in agriculture are hard to explain. In the period from 1997 to 2001, average earnings in the sector of agriculture went up almost 1.8 times and took the lead over many other economic activities. Nevertheless, the employed (possessing a job) constitute an insignificant share (approximately 10%) of the population engaged in agricultural activities. Therefore, sound conclusions about rapidly rising wages in this sector should not be made. Even more so, having in mind that the level of earnings in the agricultural sector is the lowest with the exception of hotels and restaurants.

Table 10.2 shows the structure of household disposable income as well as its dynamics.

In the 1st quarter of 2001, as compared to the 1st quarter of 2000, average disposable income per capital fell again, from LTL 398.1 to LTL 389.0 or by 2.3%. Income from employment, income from self-employment and retirement pension showed a decline, while unemployment benefits demonstrated an increase as a result of higher unemployment. ***Income in rural areas plummeted more than in urban areas and resolved in sharpening income differentiation (between cities and provinces) and social problems.***

Shrinking income from employment in provinces hardly fits rising average earnings in agriculture; nevertheless, this is partially explained by increasing rural unemployment.

The decrease in retirement pension per capita was the primary result of reduced pension payments for working pensioners.

Data on household disposable income is collected with the help of household surveys, and therefore, discrepancies in its accuracy should not entirely be ruled out. It is worth noting that the upper class of the population is not eager to reveal its true income. People avoid reporting income from illegal activities, too.

11. Investment

Investment results of late years were not favourable. As an outcome of the Russian crisis, the possibilities for Lithuanian exports have diminished and the domestic demand has decreased. Incentives for investment in production extension has dimmed, even more so having in mind the preceding under-utilisation of production capacity in a majority of firms. Not unexpectedly, last year capital investment showed a decrease of 20% over 1998 and 4% over 1999.

Nevertheless, the rise in exports that originated during the previous year laid grounds for optimistic business expectations. Sooner or later this had to trigger the investment process. During the second half of 2000, as compared to the corresponding period of 1999, capital investment slightly (3.6%) went up after a long break. Furthermore, according to provisional data, during the 1st quarter of 2001 capital investment augment-

Table 11.1

Capital Investment by Economic Activities* (LTL million)

	1996 IQ	1997 IQ	1998 IQ	1999 IQ	2000 IQ	2001 IQ
Total	**637.4**	**856.2**	**1,098.7**	**875.9**	**741.2**	**827.9**
Mining and manufacturing industry	117.3	142.3	240.8	183.3	167.8	229.3
Agriculture, hunting, forestry and fishing	17.8	15.8	22.4	18.0	9.0	14.2
Electricity, gas and water supply	63.7	71.2	80.2	84.2	70.7	64.7
Domestic trade	17.9	50.1	74.1	51.8	78.4	97.3
Transportation and storage	177.4	240.5	230.2	135.8	97.8	57.3
Post and communications	26.2	91.1	112.0	75.8	62.6	79.8
Construction of living houses	127.6	123.0	147.4	105.9	110.3	94.0
Other construction	11.0	7.1	25.2	17.3	19.0	19.0
Financial intermediation	28.0	23.0	33.0	32.4	8.2	26.0
Hotels and restaurants	3.0	2.8	13.0	9.1	6.7	8.0
Public administration and defence; Compulsory social insurance	8.2	33.2	45.4	47.3	33.3	30.0
Other activities	39.2	56.1	75.0	115.0	77.3	108.4

* Data from quarterly corporate reports

ed by already two-digit number, 11.7%. At the moment, all necessary conditions (further export growth, first signs of revival in domestic markets) for investment to keep growing all over 2001 are present. Statistics on construction permits indirectly supports this point. Permits for non-residential buildings issued in the 1st quarter of 2001 (as measured in area units) demonstrated an increase of 71.6% over a year.

Quarterly corporate reports (see Table 11.1) show that during the 1st quarter of this year the largest investment was made in the mining and manufacturing industry, i.e. 27.7% of the total investment. The investment shares of domestic trade, construction of living houses, communications and the energy sector came to 11.7%, 11.4%, 9.6% and 7.8% respectively, while the agriculture's share was only 1.7%. In the 1st quarter of 2001, investment in the mining and manufacturing industry grew at a pace of 36.7% and was the main driving force of the general increase in investment. Investment in the mining industry, the light industry, wood and wood products, and electronic equipment was surging in particular. Electronics showed an outstanding result by enlarging its capital investment 4.5 times during one year.

Currently, domestic trade and communications do not have any reasons to complain of a lack of investment, too. Their investment this quarter rose by 24.1% and 27.4% respectively.

On the other hand, capital investment in the energy sector contracted for a second consecutive year. During the 1st quarter of 2001, it fell by 8.5%. Investment in transportation and storage, which are crucial for economic growth, plunged even more, by 41.4%. A boom in construction of living houses is hardly possible, since so far the financial situation of households has not shown any vigorous improvement. In the 1st quarter of 2001, investment in construction of living houses went down by 14.7%.

An analysis of capital investment by financing sources suggests that own funds are still mostly favoured for investment purposes. During the 1st quarter own funds were used to finance 80% of the total investment and demonstrated an increase of 13.4% over a year (see Diagram 11.1).

The financing of capital investment by domestic bank loans was constantly decreasing since mid-1999. Nevertheless, in the last quarter of 2000 and the 1st quarter of 2001, it rallied by 73.5% and 102.4% respectively. In the 1st quarter of 2001, capital investment financed by funds of the national budget grew for the first time after the Russian crisis and demonstrated almost a two-fold increase (81.8%) over a year. Despite of this fact, the role of the national budget and domestic bank loans still remains minor in the financing process. During the discussed quarter, the shares of investment financed by these sources accounted for 3.7% and 4.6% respectively.

In the beginning of this year, foreign direct investment (FDI) continued to grow. Different to capital investment, the flow of FDI was not plunging over recent years. In 1999–2000, the stock of FDI in Lithuania notably increased, and at the end of the 1st quarter of this year reached LTL 9.5 billion (see Diagram 11.2.), i.e. LTL 2,715 or 679 USD per capita. In the 1st quarter, the flow of FDI at market prices, not at face value of corporate shares, amounted to LTL 534 million (see **Balance of Payments**). In 2000, flowing in FDI mainly took the form of income from privatisation, while during the 1st quarter of 2001 almost 50% of FDI consisted of reinvestment.

An analysis of FDI by different economic activities (see Diagram 11.3) shows that a robust increase was realised in mining and manufacturing, domestic trade, communications and financial intermediation. First FDI in the energy sector was accumulated only in 2000.

Diagram 11.1

Capital Investment by Financing Sources (LTL million)

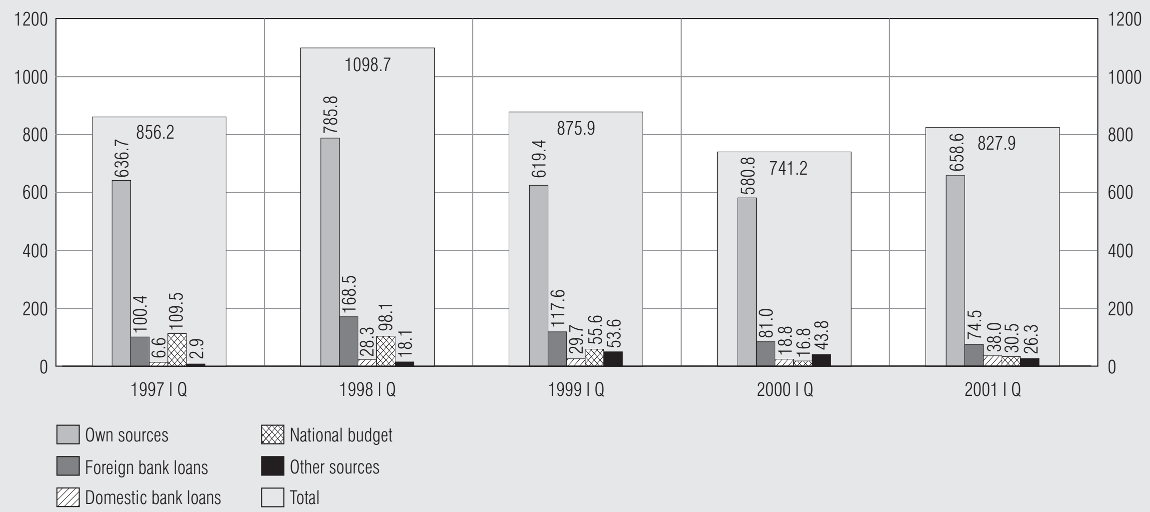
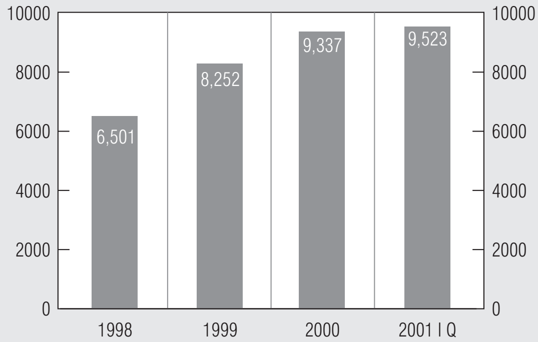


Diagram 11.2

Foreign Direct Investment (e-o-p, LTL million)



Reasonable investment in this sector is possible after its envisaged restructuring and privatisation.

Table B.4 in Appendix shows FDI by different industries and other economic activities and by investing countries. The largest investors in Lithuania are Scandinavian countries with Denmark and Sweden taking the lead. In January 2001, the share of FDI by Denmark and Sweden came to 18.3% and 17.3% respectively. Denmark topped the list (and left Sweden behind) after Danish group *Amber Teleholding A/S*, managing Swedish and Finish telecommunication companies, was recognised as a direct investor in *Lietuvos telekomas* (*Lithuanian telecom*).

Estonia, Finland and Norway were among the top ten investors, too. Their respective investment shares came to 6.4%, 6.0% and 4.3%. Scandinavian companies own a majority of Estonian companies investing in Lithuania; thus, it might be claimed that more than 50% of FDI in Lithuania has its origin in Scandinavia.

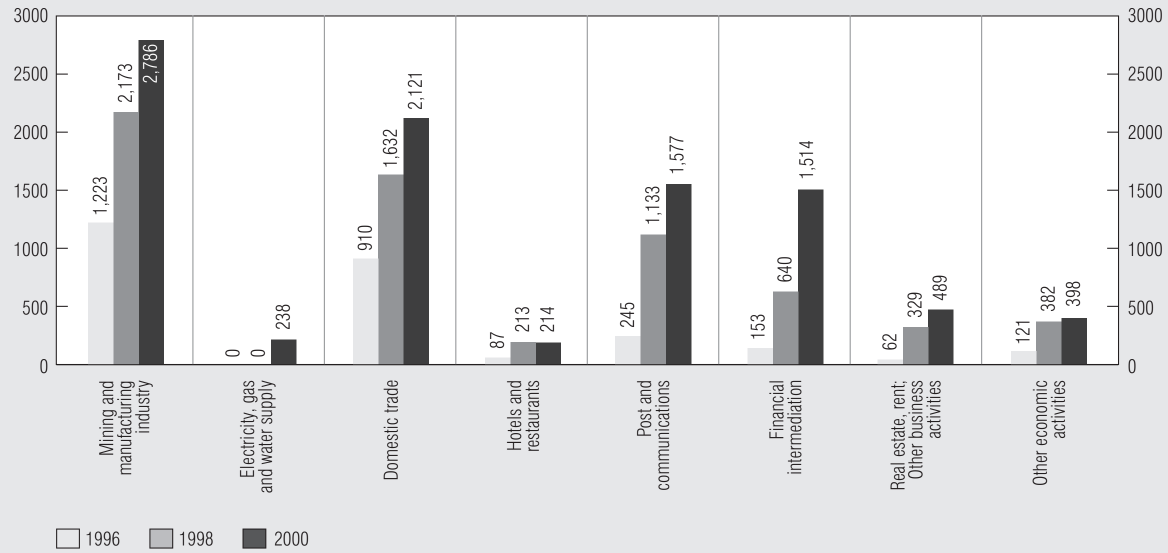
Denmark scored first by FDI in the sectors of wearing apparel, rubber and plastics. The shares of investment by this country in the sectors of transport equipment, oil extraction and communications amounted to more than half of respective FDIs. Sweden invested more than 95% of FDI in the energy sector. Swedish capital dominated the sectors of financial intermediation and wood pulp production. Scandinavian companies, mainly Finland and Norway, made more than 1/3 of FDI in domestic trade.

The USA, Germany and Great Britain followed Denmark and Sweden in being largest foreign investors in Lithuania. The three countries invested 9.8%, 7.4% and 6.7% of all FDI, respectively. The USA and Switzerland ranked first by FDI in the food and beverages industry (23.1% and 22.6%). Americans invested 1/3 of FDI in hotels and restaurants, controlled the refined oil industry and were reasonable stakeholders in the wood industry. Germany took the lead by FDI in the textile industry, had more than 25% of FDI in transport equipment production, and notably invested in domestic trade. Recently, investors from Great Britain cheered up by investing in manufacturing, trade, hotels and restaurants.

In years to come, foreign investment in the Lithuanian economy will be induced by pending membership in the European Union, strengthening confidence in the economic and financial stability of the country and the proceeding process of privatisation. The current switch of government should not be interpreted as the essential obstacle for investment.

Diagram 11.3

Foreign Direct Investment by Various Economic Activities (e-o-p, LTL million)



12. Brief Review of the Mining and Manufacturing Industry Activities

The previous issues of *Lithuanian Macroeconomic Review* have already emphasised the crucial role of the mining and manufacturing industry (particularly exporting enterprises) in overcoming the recession caused by the Russian crisis. In the 1st quarter of 2001, this sector produced about 1/4 of the Lithuanian GDP; the share of total FDI reached 30%. In 2000 capital investment in the industry was notably larger than in 1999, while the corresponding figure of the economy as a whole demonstrated a slump.

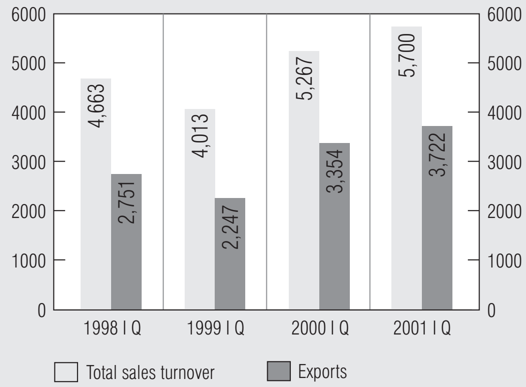
The production sales volume of the mining and manufacturing industry at current prices (henceforth this indicator interchangeably referred to as "turnover") grew by 8.2% in the 1st quarter and by 10.4% in January–May of 2001 as compared to the respective periods of the previous year (see Diagram 12.1). The turnover in 2000 increased by considerably more, i.e. 19.1%, exports augmented even by 36.3%.

Nevertheless, an analysis of dynamics in production at constant prices leads to the conclusion that this year industrial production in real terms is accelerating faster than in 2000. According to *Statistics Lithuania*, during January–May of 2001 the production sales at constant prices rose by more than 19%, i.e. notably exceeded the growth of last year, 10.7%. Fluctuations in prices explain the opposite tendencies in the above-mentioned indicators of nominal and real production sales. In 2000 the prices of oil products skyrocketed and inflated the volume of production at current prices, while this year the producer price index even diminished. Although statistical data for both 2000 and 2001 is still provisional, it should be noted that the positive trend in the industrial development has been becoming prevalent.

The level of employment in the mining and manufacturing industry has been improving as well. Last year the number workers in the mining and manufacturing measured as a share of total workers in the economy showed an increase. In the 1st quarter of this year, the number of employees adjusted to working hours per day (dynamics of which discloses changes in hidden unemployment) was approximately the same as a year ago, while the figure for the whole economy decreased by 5%. To a certain extent, this sector absorbed employees dismissed from companies of other economic activities that are being modernised or insolvent. As it is mentioned in the previous issue of *Lithuanian Macroeconomic Review,* in 2000 the general financial result of the industry was unfavourable, – corporate profits before taxes were negative and accounted for LTL –210 million. On the other hand, the relatively tiny mining industry, which accounts for only 2% of the total turnover of the sector, earned LTL 138 million profits. Unfortunately, the situation for the sector as a whole did not improve in the 1st quarter of 2001. Losses of enterprises reached LTL 49 million, i.e. several times more than in the 1st quarter of 2000.

Diagram 12.1

Production Sales of the Mining and Manufacturing Industry in the 1st Quarters of 1998–2001 (LTL million)



The financial standing of companies in the mining and manufacturing industry has become more differentiated. Companies operating successfully earned LTL 219 million profits in the 1st quarter of 2000 and LTL 255 million profits this year. However, losses suffered by unprofitable enterprises increased as well from LTL 232 million to LTL 304 million. Bankruptcy proceedings have to be instituted against an increasing number of enterprises. Therefore, the government has to strive to implement the new *Law on Bankruptcy* soundly. This problem is already pointed out not only domestically but also by foreign observers (representatives of the EU have indicated the poor execution of the *Law on Bankruptcy* as the essential discrepancy of reforms in Lithuania more than once).

12.1. Oil Extraction Industry

The growth tendencies in the output and profits of this economic activity emerged last year and even strengthened at the start of this year. In the 1st quarter of 2001, the turnover of production showed an increase of 1.5 times over a year (see Diagram 12.2). In 2000 almost all extracted oil was exported, while in 2001 *Mažeikių nafta* (*Mažeikiai Oil Refinery*) bought an insignificant volume of it as well. In the discussed quarter of this year, the growth rate of production at constant prices was quite similar to the increase mentioned above; in the 2nd quarter, it even gained some speed.

In the first half of this year, the extraction of oil in Lithuania reached 217 thousand tons, i.e. 68.3% more than a year ago. All four enterprises of this industry performed profitably and together earned LTL 31 million profits before taxes. Due to their successful performance, the collection of the tax on natural resources was three times higher than the planned one.

Minijos nafta remains the leading company of oil mining in Lithuania. In the list of the largest Lithuanian companies in 2000 published by the newspaper

Verslo Žinios, this company took 35th place by turnover (LTL 133 million) and was the third by gross profit (LTL 62 million). Only two giants, *Lietuvos Telekomas* and *Lietuvos Energija,* earned larger profits than *Minijos nafta*. During the first half of 2001 the company extracted 131 thousand tons of oil, i.e. 2.8 times more than a year ago (here and henceforth, cited data is provisional). *Manifoldas*, smallest oil mining company, enlarged its oil extraction volume even 4 times (up to 12 thousand tons). The respective indicator of *Geonafta* operations (31 thousand tons) demonstrated an increase of 1/4. In contrast, *Genčių Nafta*, second largest enterprise in the sector, curtailed down its extraction output by 22.4% to 42 thousand tons.

The intentions by companies operating in the oil mining industry to extract 0.5 million tons of oil this year are likely to be accomplished.

12.2. Food and Beverages Industry

The quite slow upsurge of the food and beverages industry, largest manufacturing activity, emerged a year ago and was related to growing exports. As it has been forecasted in the previous issues of *Lithuanian Macroeconomic Review*, in the beginning of this year, its turnover kept accelerating, and revenues from exports continued to augment as a share of total income from sales (see 12.3 Diagram). However, so far Lithuanian products have not reverted to the huge market of the recovered Russian economy. In the 1st quarter of 2001, the export of food products to this country was even smaller than a year ago. The volume of Lithuanian food exports to Russia and Latvia came up almost the same. It is worth mentioning that in July the store *Taupa*, first in the retail chain envisaged to be built in Latvia by Lithuanian *VP Market*, started to operate in Riga and may serve as an additional stimulus for the penetration of Lithuanian foodstuff in the neighbouring country.

The forecasts for the export of food products to the EU have essentially come true. The export of milk products has increased in particular and this is not surprising, because almost 20 milk processing enterprises have already acquired licenses of EU standards. The export of meat products is bounced back by the fact that Lithuanian slaughterhouses do not satisfy EU requirements. It has been concluded at the *Agrobalt* exhibition that only three meat processors – *Skinija, Vilkė* and *Mažeikių mėsinė* – meet these requirements and will get EU certificates in the near future.

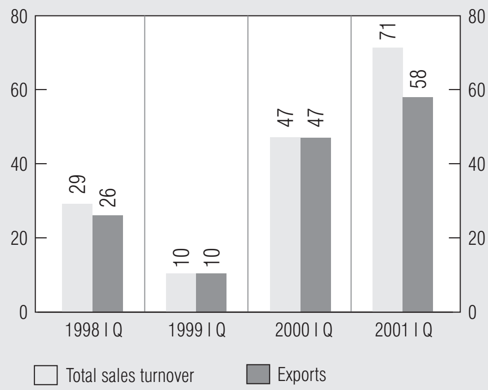
Another factor hindering the export of meat products is the shortage of raw meat in the domestic market. This shortage cannot be offset by imports because of relatively large import duties and prohibitions of certain imports by the *Veterinary Service*. The prices of raw meat are expected to accelerate and lead to the equilibrium of supply and demand in the near future. It is hard to imagine that the Lithuanian agricultural sector, which has deep cattle-breeding traditions and has employed more workers than the manufacturing industry, is incapable to provide the sufficient supply of raw meat.

In the 1st quarter of 2001, the turnover of the food industry increased by 6% as compared to the corresponding quarter of 2000. Exports accounted for 27% of the turnover. The production sales of the food industry at current prices increased by 3.7% during the year. Profitability of enterprises improved, too. In the 1st quarter, total profits before taxes amounted to LTL 8 million, i.e. several times more than in the same period of 2000. In April–May the growth rates of this economic activity slightly slowed down.

Manufacturers of ***milk and milk products*** are performing very successfully. The buying up of milk as well as the output and export of milk products have been continuously growing. The production of fat cheeses is expanding most rapidly. In the first five months of 2001, it increased by 20.2% over a year. The production of

Diagram 12.2

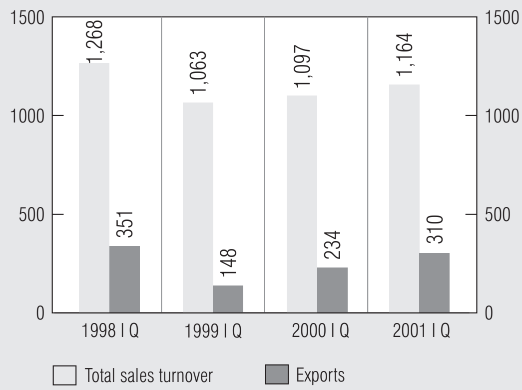
Production Sales of the Oil Extraction Industry in the 1st Quarters of 1998–2001 (LTL million)*



* Figures are calculated according to information of *Statistics Lithuania*.

Diagram 12.3

Production Sales of the Food and Beverages Industry in the 1st Quarters of 1998–2001 (LTL million)*



* Figures are calculated according to information of *Statistics Lithuania*.

milk, sour cream, yoghurt, sour milk, dried milk products pointed upward, too, while the production of curd, butter and ice cream slightly contracted.

In the first half of this year, *Rokiškio sūris*, group of several companies, continued taking the lead. Its production sales came to LTL 162 million and showed an increase of 14% over a year. In the 1st quarter, *Rokiškio sūris* earned a net profit of LTL 4.3 million, i.e. less than in the same quarter of 2000, but notably more than planned. The plan was exceeded due to the accelerated prices of ferment cheeses in Russia. The company expects LTL 8 million profits in the first half of the year. The turnover of *Pieno žvaigždės* increased by 18% and accounted for LTL 138 million. In the 1st quarter, the company earned a net profit of LTL 1.8 million, i.e. slightly more than a year ago. Profits of LTL 14.5 million are projected for 2001.

Sharpening competition induces the consolidation of the market. *Panevėžio pienas* is almost under the control of *Pieno žvaigždės.* Together with *Panevėžio pienas,* the group *Pieno žvaigždės* outstrips *Rokiškio sūris* by turnover. In the first half of 2001, the turnover of *Panevėžio pienas* demonstrated an increase of 39% and amounted to LTL 44 million. *Rokiškio sūris* merges with other companies as well. Not much time ago this company has acquired 24.9% of *Ignalinos pieninė* shares. *Žemaitijos pienas*, third largest milk processing company, is not lagging behind. In the first half of 2001, the company's turnover increased by 36% per annum and accounted for LTL 135 million. *Vilkiškių pieninė* shows the most impressive growth rates. In the period from January to May, its turnover climbed 1.6 times and reached LTL 21 million.

Kauno pieno centras, which suffered losses last year, has "broken" this negative tendency in 2001. In order to expand its activities abroad, the company purchased 100% of shares in Latvian *Livonija* and the controlling share stake of Estonian *Talinna Kulmhoone*. On the contrary, *Alytaus pieninė* is going to be included in the list of bankrupt enterprises. Nonetheless, the company does not lose hope to recover its production after the bankruptcy.

In spite of raw meat shortage, the manufacturing of ***meat products*** slightly accelerated this year. In the five-month period of this year, the output of meat and its sub-products showed an insignificant decline over a year, but it was more than offset by an increase of 14% in the output of sausages and smoked meat products. Largest Lithuanian meat processing companies sold more products than in the same period of 2000. *Nematekas* and *Vilnius mėsos kombinatas* increased their turnovers by similar amounts, about 36%. The turnover of *Biovela* showed a rise of 30%. In contrast, the turnover of *Samsonas* slightly went down. The total turnover was inflated by the accelerating prices of meat products.

Relative livestock shortage in Western Europe, which was the outcome of animal diseases, favoured the situation in the foul sector this year. Three largest poultryyards – *Vilniaus paukštynas*, *Vievio paukštynas* and *Kaišiadorių paukštynas* – have continued to increase their sales turnovers and to earn profits. *Vievio paukštynas* has achieved the most impressive results. During January–May its turnover showed an increase of 20.3% and accounted for LTL 34 million. The company earned LTL 8.1 million profits, i.e. 3.4 times more in relation to the same period of 2000.

The situation in the ***fish products sector*** is quite encouraging. During January–May of 2001 the output of fish products demonstrated an increase of 39% per year. *Kraitenė*, one of the leading fish producers in Lithuania, performed quite successfully – during the first half of the year its sales of fish products augmented by 20.2% and accounted for LTL 41 million. The company increased its ice cream sales as well, particularly in other Baltic States and in the CIS market. Another fish producer – *Vičiūnai* – has been operating satisfactory, too. *Vičiūnai* have entered and established subsidiaries in the Polish, Russian, Estonian markets. In order to facilitate exports to Scandinavian countries, *Vičiūnai* planned to take the lead of Estonian *Paljassaare Kalatoostus* (trademark ESVA) in June. *Vičiūnai* is engaged in commerce in Western Europe through its subsidiary in Belgium and permanently participates in exhibitions of a world scale.

The development of the ***grain-processing industry*** is characterised by the process of consolidation. Although in January–May the total output of flour and fodder concentrate plunged, the production sales of three largest Lithuanian grain processors went up. *Kretingos grūdai,* leading company in the sector, boosted its six months turnover up to LTL 61 million, i.e. an increase of 56.4% over a year. The company earned LTL 2.3 million net profits (in 2000 it suffered LTL 3 million losses). Export revenues amounted to LTL 20 million, i.e. several times more than a year ago. *Kretingos grūdai* has already introduced the quality system ISO 9002 and envisages to establish the environment protection system ISO 14001 this year. *Malsena* of Panevėžis has been expanding. The company has taken over *Vievio malūnas*, is drawing to an end the merger with *Skuodo malūnas* and has got a permission to acquire the *Pasvalio grūdai* elevator. In the first half of this year, the production sales by *Malsena* amounted to LTL 28 million, i.e. up by 16.6% year-on-year. *Kauno grūdai* was the second largest by turnover. The sales turnover of the company came to LTL 44 million, i.e. slightly rose over a year. Its net profits totalled LTL 2.2 million. On the contrary, *Vilniaus grūdai* has closed its mill and stopped performing.

The ***confectionery and bread industry*** did not demonstrate any significant changes this year. During January–May the output of confectionery increased by 14.7%, while the output of bread and pastry products diminished by 6.6% over a year. *Kraft Foods Lietuva* is the obvious leader of the sector. In the first half of 2001, the sales turnover of the company reached LTL 110 million and showed an increase of 3.3% year-on-year. *Vilniaus duona,* controlled by the trade group of *Vilniaus prekyba*, is one of the largest companies in the bread market. The company has ruptured negotiations with Finish *Vaasan & Vaasan* and started to reorganise the production process. *Vilniaus duona* plans to invest

LTL 72 million into the reconstruction of bakery facilities and to increase their production capacity by 50%. The problem of management crisis has at last been solved in *Naujoji Rūta*. The company *Viachema* has increased its share stake up to 91%.

In the first half of this year, the rising production of confectionery benefited ***sugar companies***. These companies sold 40 thousand tons of sugar domestically, i.e. a rise of 6.1% over a year. *Marijampolės cukrus* sold about 12 thousand tons, and the remaining share was sold by sugar factories in Kėdainiai and Panevėžis, controlled by Danish *Danisco Sugar*. In addition to the domestic sales, these companies exported 25 thousand tons of sugar.

The activities of ***brewers*** have been broadly discussed in the previous issues of *Lithuanian Macroeconomic Review*. In the first half of this year, the Lithuanian beer market expanded merely by 3.1%, as expected. Its development was slowed down by cold weather and by higher taxes on strong beer that came into force on June 1, 2001. During the first half of 2001, the production sales of *Švyturys*, leading company in the sector, reached 3.1 million decalitres (dal), i.e. were up by 22% year-on-year. The turnover of *Vilniaus tauras*, leader in the strong beer market, surged by 48.3% and came to 1.5 million dal. This company earned LTL 2.8 million profits before taxes. *Utenos alus* and *Kalnapilis* continue to be second and third largest breweries. In the first half of 2001, these companies sold 1.7 million dal of beer each, i.e. decreases of 25.5% and 24.6% over a year, respectively.

In the discussed period, *Gubernija* of Šiauliai expanded most rapidly. The brewery sold 870 thousand dal of beer and increased its turnover by 73.4%. In addition, this company is still the leading exporter of Lithuanian beer. Its sales abroad accounted for 23 thousand dal and constituted 2/3 of total Lithuanian beer exports. *Kalnapilis* increased its beer exports to the USA. In June the brewery sold 3.2 thousand dal of beer in this market.

Stumbras of Kaunas continues to keep the leading position in the ***alcoholic beverages*** market. During five months of 2001, its turnover came to LTL 38 million and was up by 1.8% over a year. On the other hand, the production sales of *Vilniaus degtinė* demonstrated a decrease of 28.6% year-on-year and accounted for only LTL 9.6 million. The financial indicators of these companies were different as well. *Stumbras* earned LTL 3.6 million profits, while *Vilniaus degtinė* suffered 0.6 million losses. *Stumbras* has started to produce several new types of brandy. Furthermore, the company plans to produce the ethanol – ecologically clean fuel for cars – in its spirits factory in Šilutė.

The largest sparkling wine producer *Alita* of Alytus is widening its assortment of products. One of its new products is the cocktail *MIX* (alc. 6 %). Besides, the company holds a share of about 20% in the vodka (strong alcoholic beverages) market and envisages strengthening its position there. In January–June 2001, the company's turnover rose by 2.5% and came to LTL 22 million. *Alita* is going to easily reach this year's plan of turnover, i.e. LTL 70 million. However, the expected profit of LTL 5–6 million will be hardly achievable because of sharpening competition in the market of concentrated juices.

In the first half of 2001, the turnover of *Anykščių vynas,* leading wine producer, went down by 38.6% and added up to LTL 22 million. The unprofitable performance of the company is not surprising. Nevertheless, the revised *Law on Excise Duties* has set favourable preconditions to reduce the prices of wines and to let wineries earn profits this year.

12.3. Light Industry

The light industry, consisting of manufacturing of textiles, wearing apparel and leather products, traditionally is second largest industrial sector. In 2000 the value added by the largest industrial activity – food and beverages industry – accounted for 26% of the total value added by the mining and manufacturing industry, and the respective figure of the light industry was 17.5%. The number of workers in the former accounts for 23% and in the latter – 25% of all jobholders in the mining and manufacturing industry.

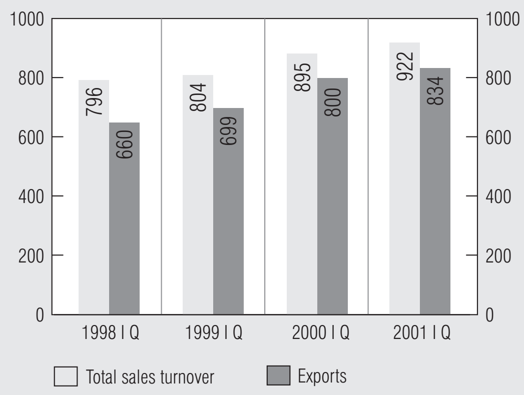
In the beginning of this year, the light industry performed quite successfully. In the 1st quarter, its turnover and exports increased by 3.0% and by 4.2% year-on-year, respectively (see Diagram 12.4). During April–May the turnover accelerated and therefore in the five month period of 2001 showed a rise of 8.2% (8.8% at constant prices) over a year. The output of textiles and leather products grew by more than 20%, while the output of wearing apparel contracted. Notable increases were recorded in the outputs of the following: linen-type fibres, carpets, knitwear, and woollen fabrics (an increase of 2 times). In contrast, the outputs of cotton and linen fabrics diminished. In the 1st quarter of 2001, gross profits earned by companies operating in the light industry totalled LTL 22 million and demonstrated an increase of 4 times over a year.

Lithuanian membership in the World Trade Organisation (WTO) will bring opportunities for the light industry to penetrate new markets. At present, about 80% of light industry's exports go to the EU, i.e. the region with which zero duty tariffs are in force. More and more goods are sold in this market. In the near future, however, Lithuanian exporters will have to get certificates of ISO standards in order to stay successful in foreign markets. Currently only 6 out of 140 members of *Lengvosios pramonės įmonių asociacija* (*Association of Light Industry Enterprises*) possess the quality control certificates ISO 9001. Ecological ISO certificates are very important as well. *Utenos trikotažas*, *Linų audiniai* and *Siūlas* are first companies in the country to be granted the ISO 14001 certificate in September.

In the first half of this year, the turnover of *Utenos trikotažas* grew at a slower pace. Its production sales came to LTL 63 million and showed a slight increase over a year. Nevertheless, it was enough to ensure profitable performance. In the 1st quarter, gross profits totalled LTL 4.9 million, i.e. were up by 34% year-on-year. The company envisages earning LTL 11 million net profits and reaching LTL 125 million turnover this year.

Diagram 12.4

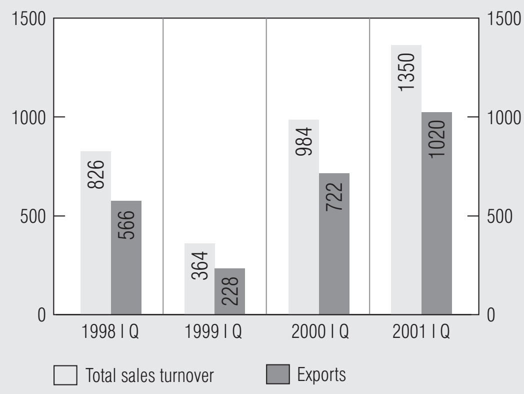
Production Sales of the Light Industry in the 1st Quarters of 1998–2001 (LTL million)*



* Figures are calculated according to information of *Statistics Lithuania*.

Diagram 12.5

Production Sales of the Refined Oil Industry in the 1st Quarters of 1998–2001 (LTL million)*



* Figures are calculated according to information of *Statistics Lithuania*.

Unfortunately, *Alytaus tekstilė* cannot still overcome difficulties. In the first half of the year, its turnover went down by 15.4% over a year and ended up at LTL 72 million. Although at the end of 2000 the company started to perform profitably, it suffered LTL 4.1 million losses this year. Headquarters of *Alytaus tekstilė* deny the spreading rumours about bankruptcy (there are 3000 workers in the company) and affirm that modern equipment, valued LTL 23 million, are on their way to the company. This means that the strategic investor *Tolaram Group* of Singapore has started to meet its investment obligations to enlarge production in Alytus. *Tolaram Group* intends to merge *Alytaus tekstilė* and Estonian *Baltex 2000*, controlled by the Singaporeans as well. G. Andriuškevičius, who has run *Alytaus tekstilė* for many years, has been appointed to manage *Baltex 2000*. Both companies in Lithuania and Estonia manufacture analogous products. *Baltex 2000* is short of labour force, but *Alytaus tekstilė* has many qualified workers and free space for production. Despite of losses suffered at the start of the year, *Alytaus tekstilė* envisages to perform profitably in the nearest future.

Drobė, manufacturer of woollen fabrics, has got an influx of investment after its privatisation and has significantly improved production results. The company suffered LTL 6.5 million losses last year. Nevertheless, in the first half of this year, its turnover accounted for LTL 43 million and was up by 27% as compared to the respective figure a year ago. Its production exports to Italy and Germany increased in particular.

Audėjas of Vilnius, producer of furniture fabrics, operated successfully in the beginning of the year, too. The company obtained the quality certificate ISO 9001; increased its turnover and profits. At the international exhibition in Kazakhstan *Audėjas* was granted the diploma of high products quality.

Lately *Audimas* of Kaunas, producer of sportswear, has been rapidly expanding and operating profitably. In the beginning of 2001, the company continued to increase its turnover. In the 1st quarter, its production sales rose by 61% year-on-year. *Audimas* has started to run a brand store in Vilnius, but as much as 90 % of its output is exported. The company is a supplier of furniture fabrics to Swedish IKEA, which has acknowledged *Audimas* as the best business partner of 2000 in the Baltic States. *Audimas* intends to obtain the ISO 9001 certificate this autumn.

In the beginning of the year, the turnovers of *Kauno audiniai* and *Liteksas* contracted. Both companies incurred losses. *Trinyčiai* and *Linas* operated unprofitably, too. Nevertheless, authorities of all these companies are optimistic about the future. New equipment has been delivered from English *Shiloh Spinners* to *Trinyčiai* and is being installed. The new instalment is likely to double the production capacity of *Trinyčiai*. *Liteksas* has also decided to spend LTL 36 million on production reorganisation and envisages completing it this year. *Linas* has acquired raw materials very cheaply and expects to earn profits in 2001.

Šiaulių Stumbras, processor of leather, has been expanding very rapidly. Last year its turnover totalled LTL 64 million and showed an increase of 1.5 times, while net profits accounted for LTL 2 million and demonstrated a rise of 3.5 times. The turnover and profits of the company are expected to reach LTL 100 million and LTL 3 million, respectively, in 2001. The results of the first half of the year show that these plans are realistic. Meanwhile, *Šiaulių Stumbras* is not able to meet all received orders in time because demand for its products is huge as a consequence of the existing shortage of genuine leather in the EU.

12.4. Refined Oil Industry

The role of the refined oil industry in the Lithuanian economic development is overvalued quite often. This sector produced only 1.1% of GDP in 2000. From this standpoint, the industry of oil products is compatible with such industrial activities as the manufacturing of chemical products, publishing, and the furniture sector. In contrast, it is notably smaller than the manufacturing of electrical and optical equipment or wood and wood products and almost incompatible with industrial giants – food and light industries. The number of employees in the refined oil sector constitutes only about 2% of all workers in the mining and manufacturing industry.

Nevertheless, this sector cannot be ignored. As a result of the improved supply of raw materials from the East, during the 1st quarter of this year, the turnover and export of oil products amounted to LTL 1.4 billion (an increase of 37.2% year-on-year) and LTL 1.0 billion (41.3%), respectively (see Diagram 12.5). These figures were the highest among the results of all industrial activities. During April–May the growth rate of the sector gained even more speed. In five months of 2001, *Mažeikių nafta*, monopolist in the sector, increased its processing of raw materials by 41% as compared to a year ago. The company's turnover went up by 54.5% and accounted for LTL 2.4 billion. The turnover at constant prices turned up by a similar amount.

It is almost clear that production will not decrease in the second half of the year as well. The previous issue of *Lithuanian Macroeconomic Review* has evaluated the prospects of negotiations between *Mažeikių nafta* and Russian *Lukoil* sceptically. Indeed, these negotiations have snapped. Nevertheless, in parallel with negotiations with *Lukoil*, *Mažeikių nafta* has been on secret talks about the long-term supply of crude oil with another Russian company – *Jukos. Mažeikių nafta* and *Jukos* have reached an agreement that entirely satisfies the needs of the former. According to the agreement, *Jukos* is going to acquire about 27% of *Mažeikių nafta* shares in exchange for the guaranteed long-term supply of crude oil. The agreement will finally allow evading losses of *Mažeikių nafta* that amounted to LTL 179 million last year and additional LTL 13 million in January–May of 2001 (under USA accounting standards).

12.5. Wood, Furniture and Paper Industry

Recently this sector has not experienced any significant changes. In the 1st quarter of the year, the turnover and export of the industry continued to grow (see Diagram 12.6). During five months of 2001 the turnover totalled LTL 1.1 billion, was up by 23.3% per annum (28.4% at constant prices) and constituted about 11% of the total turnover of the mining and manufacturing industry. The number of employees in the sector accounted for about 19% of the corresponding indicator of the mining and manufacturing industry. In the 1st quarter of this year, gross profits of companies operating in the discussed industry amounted to LTL 10 million, while a year ago the figure was negative and equalled LTL -4.6 million. Furniture producers earned highest profits. So far the manufacturing of paper and wooden fibre has been unprofitable.

12.6. Industry of Chemicals and Chemical Products

In the light of industrial activities examined in this issue of *Lithuanian Macroeconomic Review*, the chemical industry, and particularly its sub-sectors of fertilisers and acetate yarn, faced most severe difficulties in the beginning of 2001. Diagram 12.7 shows the turnover and export of the industry in the 1st quarters of 2000 and 2001. In the first five months of 2001, the turnover decreased by 11.6% per year (by 21% at constant prices) and came to LTL 520 million. As a result, the share of this sector in the total output of the mining and manufacturing industry shrank from 6.6% in 2000 to 5.2% in January–May of 2001. The output of fertilisers declined by 25% per year. The output of phosphate fertilisers shrank very significantly, while the output of nitrogenous fertilisers decreased rather slightly (9%).

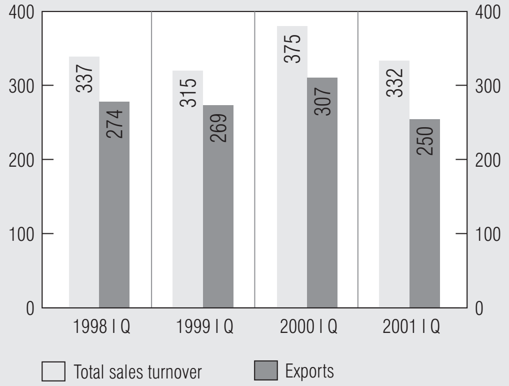
Diagram 12.6

Production Sales of the Wood, Furniture and Paper Industry in the 1st Quarters of 1998–2001 (LTL million)*

* Figures are calculated according to information of *Statistics Lithuania*.

Diagram 12.7

Production Sales of the Chemistry Industry in the 1st Quarters of 1998–2001 (LTL million)*



* Figures are calculated according to information of *Statistics Lithuania*.

The output of acetate yarn declined as much as 1.5 times. On the contrary, the output of medicaments increased a lot. Total losses of sector's companies in the 1st quarter of the year amounted to LTL 30.5 million and almost doubled as compared to a year ago. *Dirbtinis pluoštas*, the only acetate yarn producer in the Baltic States, has been announced bankrupt. The company has been suffering losses for a few years in a row. It incurred a loss of LTL 48 million in 2000 and LTL 10 million in the 1st quarter of this year. Despite of a drop in production volumes, *Dirbtinis pluoštas* has held a share of about 27% in the European acetate yarn market.

Lifosa, manufacturer of phosphorus fertilisers, is not doing well, too. Due to the unfavourable situation in the international phosphate fertiliser market, the company has suspended its production or operated not at a full capacity for several times. In the 1st quarter of 2001, its turnover plunged 2.4 times down to LTL 47 million, and losses increased 1.9 times up to LTL 22 million. In 2000, *Lifosa* suffered LTL 96 million losses.

The ambitious business plans of pharmaceutical producers for this year have not been entirely accomplished. In the first half of this year, the turnover of the largest pharmaceutical company *Sanitas* was similar to the level of the same period in 2000, LTL 12 million. During five months, the company earned LTL 0.3 million profits. The plans were not fully met due to the slackening export of medicaments to Russia. The turnover of *Endokrininiai preparatai* increased by 32% and accounted for LTL 8.5 million. However, the company incurred losses.

12.7. Industry of Rubber and Plastic Products

Lately this sector has been dynamically expanding. During five previous years, its share in the total output of the manufacturing industry increased 3 times. The expansion did not slow down in the beginning of this year as well. The sector's production sales are shown in Diagram 12.8. During January–May, the turnover came to LTL 276 million and was up by 18.4 % (24.5% at constant prices) year-on-year. About half of the output was exported. In the 1st quarter of 2001, gross profits of companies operating in the discussed industry amounted to LTL 1 million, i.e. 2 times less in relation to the same period of 2000. The differentiation process has become more obvious in the sector. Both profits of successfully operating companies and losses of companies facing difficulties have increased. In 2000 the largest company of the sector – *Nemuno banga* – earned revenues of LTL 185 million and profits of LTL 16 million (and topped the tenth in the list of the largest Lithuanian companies published by the newspaper *Verslo Žinios*).

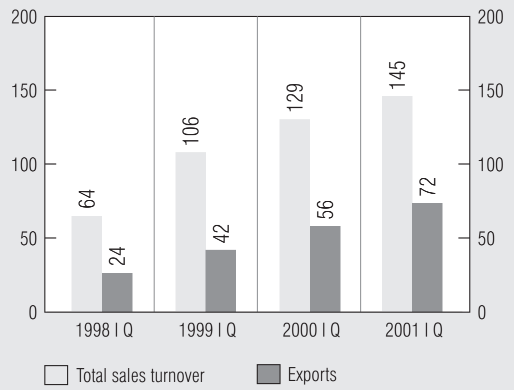
12.8. Industry of Other Non-metallic Mineral Products

This industry is closely related to the still stagnating construction sector and therefore was not moving onwards in the first half of the year. On the other hand, the recession has come to an end. In the 1st quarter of 2001, the turnover was down by 3% year-on-year (see Diagram 12.9), while in five months of the year this indicator increased by 1.6% as compared to the corresponding period of 2000.

The turnover of the largest company of the sector – *Akmenės cementas* – came to LTL 28 million in January–May and slipped down by 16.3% over a year. The company suffered losses of LTL 3.1 million, i.e. almost two times less than a year ago. In May–June *Akmenės cementas* operated profitably. The company's results for the full year 2001 will largely depend on the government decision to extend or cancel the validity of anti-dumping duties on cement imports from the East.

Diagram 12.8

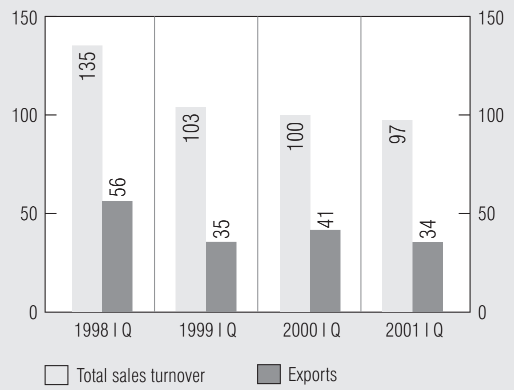
Production Sales of the Industry of Rubber and Plastic Products in the 1st Quarters of 1998–2001 (LTL million)*



* Figures are calculated according to information of *Statistics Lithuania*.

Diagram 12.9

Production Sales of the Industry of Other Non-metallic Mineral Products in the 1st Quarters of 1998–2001 (LTL million)*



* Figures are calculated according to information of *Statistics Lithuania*.

The turnover of *Dvarčionių keramika* during the first half of the year totalled LTL 23 million (i.e. approximately the same like in the corresponding period of 2000). The company earned LTL 0.7 million profits. Although the turnover did not rise, *Dvarčionių keramika* has significantly enlarged its sales abroad and envisages closing this year with profits.

In the beginning of the year, *Gargždų mida*, producer of roof covers, operated unprofitably. Nevertheless, the company hopes to increase its turnover up to LTL 16 million by the end of the year and to earn profits. Foreign producers of roof covers have shown their interest in *Gargždų mida* and are potential investors in the company.

12.9. Industry of Machinery and Appliances

This industrial activity has been encountering difficulties for already several consecutive years. The previous issues of *Lithuanian Macroeconomic Review* have identified this industry as being most unprofitable. Furthermore, its output measured as a share of the total industrial output has been diminishing since 1995. Therefore, the production growth of this sector in the beginning of 2001 was a bit unexpected. In the first quarter of this year, the turnover showed an increase, while the volume of exports remained constant (see Diagram 12.10). During April–May the growth even accelerated and the turnover of five months came to LTL 190 million, i.e. increased by 17.6% (22.5% at constant prices) per annum. Unfortunately, companies operating in the reviewed industry did not reach positive financial results. Their losses totalled LTL 21 million and rose by LTL 2 million year-on-year.

Oruva of Mažeikiai is one of the representatives of the machinery and appliances industry. The company has been incurring losses. Investments in the *Oruva* production shop of diesel engines have reached LTL 100 million, but recently the shop has been leased for a symbolic price of LTL 1. Other representative company, *Snaigė* of Alytus, has got over difficulties and during January–May earned LTL 2.8 million net profits (a year earlier, it suffered losses of a similar scope). In the first half of the year, the turnover of *Snaigė* accounted for LTL 83 million, i.e. was up by 36% over a year.

Amalva of Vilnius, producer of ventilation systems, is currently expanding its facilities. The company's turnover came to LTL 9.5 million during the previous year and demonstrated an increase of 46% over 1999. *Amalva* has started to construct new production shops and warehouses next to its currently operating factory. This will allow enlarging the existing production capacity 5 times. *Vienybė* of Ukmergė is extending its production as well. Last year the turnover of the company accounted for LTL 31 million and was 28% higher than in 1999.

Although in 2000 the turnover (LTL 16 million) of *Astra* of Alytus was nearly the same as in 1999, the company envisages increasing its output by 30% in 2001.

12.10. Industry of Electrical and Optical Equipment

This sector has expanded quite successfully over recent years; its production sales and profits have augmented. Unfortunately, in the 1st quarter of this year, both the turnover and export contracted (see Diagram 12.11). Nevertheless, gross profits earned by companies operating in the discussed industry totalled LTL 33 million and exceeded the corresponding indicator a year earlier even 2.2 times. All three main activities of the sector – manufacturing of electrical machinery and equipment, manufacturing of electronics and manufacturing of medical and precision instruments – operated profitably. During April–May the total output of the sector increased, therefore the turnover of five months (LTL 580 million) was slightly higher than a year ago

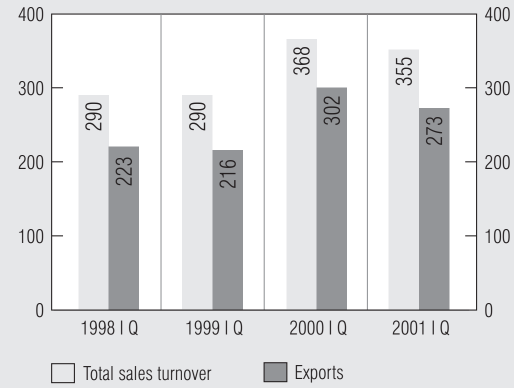
Diagram 12.10

Production Sales of the Industry of Machinery and Appliances in the 1st Quarters of 1998–2001 (LTL million)*

* Figures are calculated according to information of *Statistics Lithuania*.

Diagram 12.11

Production Sales of the Industry of Electrical and Optical Equipment in the 1st Quarters of 1998–2001 (LTL million)*



* Figures are calculated according to information of *Statistics Lithuania*.

(production sales at constant prices decreased by 4%). The industry of electronics, which has grown very rapidly during last years, stopped soaring in 2001. This slowdown was predetermined by the crisis in Turkey, one of the main export markets of *Ekranas* of Panevėžis.

In the first half of 2001, the turnover of *Ekranas* came to LTL 208 million and shrank by 5.9% over a year. On the other hand, the net profit of the company grew by 1.2% and amounted to LTL 28 million. Authorities of *Ekranas* envisage increasing sales and profit up to LTL 500 million and LTL 60 million, respectively, during this year.

In the first half of the year, the turnover of *Vilniaus Vingis* amounted to LTL 66 million and was up by 10.4% per annum. The company operated profitably and planned reaching LTL 150 million turnover and LTL 9.2 million net profits in 2001.

This year *Šiaulių Tauro televizoriai* started direct negotiations with retail trade networks in Europe. According to headquarters of the company, if negotiations were completed successfully, *Šiaulių Tauro televizoriai* would be flooded with a huge number of orders in autumn. The company let running the second production line before summer vacations. The new production line enlarged the production capacity to 30 thousand TV sets per month. At the end of August, *Šiaulių Tauro televizoriai* are going to start producing monitors for computers. Unfortunately, in the 1st quarter of the year, the company's turnover contracted by 36.6% and accounted for LTL 17.6 million. The company earned not significant profits.

Lietkabelis of Panevėžis, largest producer of electrical wires in Lithuania, boosted its sales by 48% last year as compared to 1999. In the 1st quarter of this year, the company's turnover grew by additional 9.1% and accounted for about LTL 10 million. *Lietkabelis* is operating profitably and intends to start the installation of a new line of enamelled wires in August.

13. Financial Markets

13.1. Money Supply and Official International Reserves

In the 1st quarter of this year, the monetary base (money outside the *Bank of Lithuania* (BoL) and commercial banks' reserves with the BoL) scaled down to the lowest level of the reviewed period and reflected the limited demand for central bank's money (see Table 13.1).

The most important component of the monetary base, money in circulation, showed a decrease of 6.6% over the end of 2000. This should not be surprising, because during Christmas and New Year's holidays the demand for cash is usually rising. Cash holdings of litas by commercial banks are quite unstable over a maintenance period of required reserves; their amount at the close of a month also depends on random factors.

The indicator of net foreign currency purchases by the BoL is more expressive. In the 1st quarter of 2001, the central bank sold to commercial banks US$ 115.1 million more than it bought from them. Just because of this reason the monetary base decreased by LTL 460.4 million. In April, the BoL remained a net seller of foreign currencies, by selling US$ 17.9 million more than buying. In May and in June, the opposite held true. Net foreign currency purchases by the BoL were positive and accounted for US$ 15.6 million and US$ 38.1 million, respectively. ***In the first half of this year, trade in foreign currencies between commercial banks and their clients was characterised by the traditional feature: banks were net buyers of foreign currencies in cash, but net sellers of foreign currencies in non-cash operations.***

Table 13.1

Changes in Monetary Aggregates (LTL million)

End-of-period	Components of the monetary base				Components of the M2 monetary aggregate				
	Currency outside the BoL	Commercial banks' reserves in litas	Required reserves of commercial banks in foreign currencies	Monetary base (Total)	Currency in circulation	Demand deposits	Time and savings deposits	Foreign currency deposits	Broad money (M2) (Total)
12 1998	3,036.1	867.8	344.0	4,247.9	2,800.4	2,770.3	749.7	2,006.7	8,327.1
	*71.4**	*20.4*	*8.1*	*100.0*	*33.6*	*33.3*	*9.0*	*24.1*	*100.0*
12 1999	2,971.7	444.6	435.6	3,852.0	2,738.7	2,536.1	972.4	2,724.6	8,971.9
	77.1	*11.5*	*11.3*	*100.0*	*30.5*	*28.3*	*10.8*	*30.4*	*100.0*
06 2000	2,810.3	477.2	445.5	3,733.0	2,643.6	2,474.1	1,191.5	3,025.5	9,334.7
	75.3	*12.8*	*11.9*	*100.0*	*28.3*	*26.5*	*12.8*	*32.4*	*100.0*
12 2000	2,904.2	620.6	415.9	3,940.8	2,658.3	3,014.2	1,228.4	3,554.5	10,455.4
	73.6	*15.7*	*10.6*	*100.0*	*25.4*	*28.8*	*11.7*	*34.0*	*100.0*
03 2001	2,713.8	553.1	396.3	3,663.2	2,511.4	2,787.0	1,468.0	3,846.5	10,611.9
	74.1	*15.1*	*10.8*	*100.0*	*23.7*	*26.3*	*13.8*	*36.2*	*100.0*

* Shares (%) of components are given in *Italics*.

Net foreign currency purchases by the BoL had influence on fluctuations in official international reserves, but they were not the only variable causing a change. Another factor, affecting official international reserves, but having no direct relationship with the monetary base, was central government deposits in foreign currencies with the BoL. They climbed to US$ 349 million in February of this year as a result of proceeds from EUR 200 million eurobond issue reaching government accounts with the BoL. After the government had started to spend these funds, its accounts with the BoL as well as official international reserves contracted. Nevertheless, the latter indicator notably pointed upward in June 2001 and demonstrated a slight increase over a year. It came to US$ 1,454.6 million in June 2001 and US$ 1,424.3 million in June 2000. In the reviewed period, the high-powered money remained to be well covered with official international reserves (see Diagram 13.1).

In the 1st quarter of 2001, as compared to the previous quarter, the monetary aggregate M2 continued to follow its growth trend and turned up by 1.5%. As usually, an increase in foreign currency deposits was one of the main growth drivers. Nonetheless, in the discussed quarter, time and savings deposits in litas also notably rose and brought their positive contribution (see Table 13.1). On the other hand, money in circulation and demand deposits went down. Their decrease was not so large as the increase in the above mentioned variables, and thus did not outweigh but just slackened the quite rapid growth of M2.

In recent years the broad money expanded due to intense saving, while the monetary base stayed stiff. As a result, the ratio of these two indicators or so called the money M2 multiplier robustly increased: in 1998 it was 1.96, in 1999 – 2.33, in the 1st quarter of 2000 – 2.41, and in the 1st quarter of 2001 – 2.90.

13.2. Activities of Credit Institutions

At the close of the 1st quarter of 2001, the assets of commercial banks operating in Lithuania were LTL 13.6 billion and showed an increase of 3.8% over the end of the previous year. The loan portfolio of banks went up to LTL 5.6 billion, i.e. increased by 2.2%. Deposits at banks were growing at a pace similar to the previous year's rate. On April 1, 2001, they summed to LTL 9.2 billion and showed an increase of 6.5% over a quarter. Deposits of individuals amounted to LTL 5.3 billion, i.e. an increase of 5.8% (see Table 13.2).

The increased portfolio of loans was one of the best news in the banking sector during the 1st quarter of 2001. This is associated with the revived process of capital investment that started to emerge during the last quarter of the previous year. The volume of mortgage loans has also begun to grow more rapidly, though the huge potential of borrowing is far from being exhausted mainly due to unfavourable prospects of the financial situation of house-

Diagram 13.1

Official International Reserves and BoL Liabilities in Litas

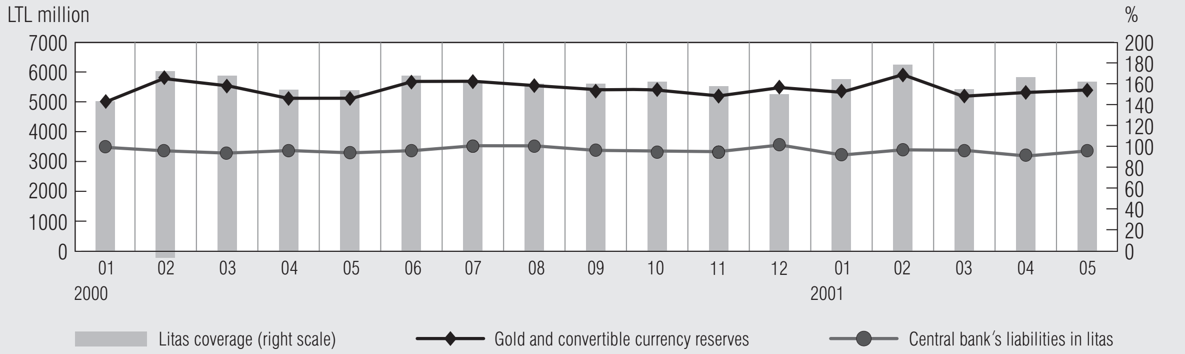


Table 13.2

Main Indicators of Banks (LTL million)

Balance sheet entry	04 01 2000	01 01 2001	04 01 2001	Change per IQ (%)	Change per year (%)
Assets	11,409.7	13,095.3	13,597.2	3.8	19.2
Loans for clients	5,361.9	5,519.1	5,642.3	2.2	5.2
Special provisions on loans	244.2	205.9	212.4	3.2	–13.0
Deposits and letters of credit:	7,254.6	8,596.1	9,152.6	6.5	26.2
Individuals	4,188.4	5,043.3	5,337.6	5.8	27.4
Private companies	1,980.4	2,470.4	2,464.0	–0.3	24.4
Shareholders' equity	817.8	815.8	815.8	0.0	–0.2

holds. Meanwhile banks intensively introduce new loan products for individuals and reduce interest rates.

As it is stated in the previous issue of *Lithuanian Macroeconomic Review*, an increase in the loan portfolio in 2001 is the necessary condition for sustainable economic growth, because own sources of companies are not sufficient to finance substantial investments. In addition, the propensity to borrow is expected to go up in line with brightening business prospects. This year the total loan portfolio of banks will rise relatively insignificantly, i.e. by 10–12%, but next year a mighty hike is likely.

Like in the past, banks are not eager to raise their capital. There are not enough profitable (and at the same time riskier) investment alternatives and the capital adequacy requirement is excessively met by them. On April 1, 2001, the capital adequacy indicator came to 16.44% and was significantly higher than the BoL's required minimum of 10%. Constantly growing individual and corporate deposits are more than enough to credit local clients.

In the 1st quarter of 2001, eight banks and two branches of foreign banks were profitable and earned a total of LTL 39.7 million profits. Two banks and two branches of foreign banks encountered losses of LTL 2.8 million (see Table 13.3).

The improved efficiency of bank activities was the main reason for the better results of the whole banking system. In the 1st quarter of 2001, as compared to the corresponding period of 2000, the ratio of banks' operational costs to gross revenues declined from 38.2% to 31.7%. The ratio of wages and other related costs to revenues shrank, too.

Although the profit of the banking system almost doubled in the 1st quarter of 2001 as compared to a year ago, the financial results of some smaller banks became worse. Redistribution of market niches and sharpening competition were some of the explanations.

The quality indicators of the bank loan portfolio slightly deteriorated (see Table 13.4).

The trivial increase in the ratio of special provisions on non-performing loans should not be dramatised. The share of long-term loans has already been growing for several years in a row. In the 1st quarter of 2001, this share went up even more, from 60% to 62% of the loan portfolio. It is a very welcome fact in terms of credit-

Table 13.3

Profits of Banks Operating in Lithuania in the 1st Quarters of 2000 and 2001 (LTL million)

Bank	04 01 2000	04 01 2001
1. *Lietuvos žemės ūkio bankas*	1.6	4.7
2. *Lietuvos taupomasis bankas*	3.4	11.4
3. *Ūkio bankas*	–0.4	0.5
4. *Vilniaus bankas*	16.7	20.2
5. *Šiaulių bankas*	0.3	0.1
6. bankas *Snoras*	1.6	0.4
7. *Medicinos bankas*	0.1	0.6
8. *Parex bankas*	–1.2	–1.6
9. *Hansabankas*	–1.6	–0.1
10. *Sampo bankas*	—	0.8
11. *Kredyt bank S.A.* Vilnius branch	2.0	–0.2
12. *Norddeutsche Landesbank Girozentrale* Vilnius branch	–2.6	0.7
13. *Merita Bank Plc* Vilnius branch	—	–0.9
14. *Vereins- und Westbank* AG Vilnius branch	—	0.2
Total	**19.9**	**36.8**

Table 13.4

Quality of the Bank Loan Portfolio

Date	Special provisions on non-performing loans/Extended loans	III, IV, V group loans/All loans
01 01 1998	18.52	28.25
01 01 1999	5.92	12.46
01 01 2000	4.47	11.92
07 01 2000	4.34	15.76
01 01 2001	3.73	10.79
04 01 2001	3.76	11.29

Table 13.5

Resident Deposits by Maturity (LTL million)

	Total	Of which					
		Up to 1 month	1–3 months	3–6 months	6–12 months	1–2 years	Over 2 years
In litas							
2000 IQ	2,324.5	1,664.3	313.1	205.7	113.2	27.8	0.4
	*100.0**	*71.6*	*13.5*	*8.8*	*4.9*	*1.2*	*0.0*
IIQ	2,375.4	1,638.0	332.7	234.5	130.8	36.5	2.8
	100.0	*69.0*	*14.0*	*9.9*	*5.5*	*1.5*	*0.1*
IIIQ	2,846.6	2,129.1	312.5	250.5	117.2	36.3	1.0
	100.0	*74.8*	*11.0*	*8.8*	*4.1*	*1.3*	*0.0*
IVQ	3,311.2	2,548.6	249.7	290.0	161.2	60.4	1.4
	100.0	*77.0*	*7.5*	*8.8*	*4.9*	*1.8*	*0.0*
2001 IQ	3,219.3	2,243.3	395.8	292.2	215.6	70.3	2.1
	100.0	*69.7*	*12.3*	*9.1*	*6.7*	*2.2*	*0.1*
In foreign currencies							
2000 IQ	2,735.0	1,454.8	546.7	498.5	191.1	35.7	8.1
	100.0	*53.2*	*20.0*	*18.2*	*7.0*	*1.3*	*0.3*
IIQ	3,495.1	2,069.9	548.8	539.3	269.4	57.4	10.1
	100.0	*59.2*	*15.7*	*15.4*	*7.7*	*1.6*	*0.3*
IIIQ	3,549.0	2,139.1	550.2	521.0	280.6	57.8	0.2
	100.0	60.3	*15.5*	*14.7*	*7.9*	*1.6*	*0.0*
IVQ	4,113.6	2,340.6	585.1	712.0	356.6	117.6	1.7
	100.0	*56.9*	*14.2*	*17.3*	*8.7*	*2.9*	*0.0*
2001 IQ	3,959.5	2,331.3	592.9	587.2	342.2	104.5	1.6
	100.0	*58.9*	*15.0*	*14.8*	*8.6*	*2.6*	*0.0*

* Shares (%) of different maturity deposits in total deposits are given in *Italics*.

ing the corporate development, though long-term loans urge banks to take higher credit risk, related to the problems of forecasting business prospects as well as the financial situation of a borrower in the future.

Table 13.5 shows that in the 1st quarter of 2001 resident time deposits slightly decreased as compared to the last quarter of the previous year. The share of up to 1-month deposits in litas contracted, and the share of other maturity deposits in litas increased at its expense. The deposits with 6–12 month or longer maturity (i.e. the repayment of which will take place after re-fixing the litas) grew in both relative and absolute terms. This signals that ***corporate and individual clients are not afraid of devaluation of the litas during its re-pegging from the US dollar to the euro.***

There were no significant shifts in the structure of time deposits in foreign currencies in terms of maturity (see Table 13.5), but the proportion of deposits in US dollars and in euro changed notably. In the last quarter of 2000, the share of deposits in US dollars accounted for 96.0% and the share of deposits in euro – only 4.0%. In the 1st quarter of 2001, the former came to 86.1% and the latter climbed to 13.9%. This tendency endured in April–May, too. It should be mentioned that the maturity of almost all deposits in euro was not exceeding 1 month. Therefore, it cannot be concluded that in the wake of re-pegging the litas market players have started to save in euro. Instead, this indicates that foreign trade operations are increasingly settled in euro and other EMU currencies, and that such trade proceeds are held in banks for shortest time terms and used for transaction purposes.

In the 1st quarter of this year, the volume of extended loans in both litas and foreign currencies went up (see Table 13.6). Special attention should be given to the increase in the share of loans with the longest maturity (over 5 years). The share of over 5 years loans in litas rose from 6.3% to 18.3%, and in foreign currencies – from 14.3% to 20.2%. Long-term loans were mainly granted to companies, while borrowing by individuals is too insignificant to have any influence on aggregate results. The increase in long-term crediting of companies is closely related to the reviving investment process.

A higher possible growth rate of loans in litas is constrained by the lack of deposits with corresponding maturity rather than the demand for credits. Existing inconsistency in the maturity of supplied deposits and demanded loans raise the price of borrowing. The ability

Table 13.6

Loans to Residents by Maturity (LTL million)

	Total	Of which					
		Up to 1 month	1–3 months	3–6 months	6–12 months	1–5 years	Over 5 years
In litas							
2000 IQ	167.8	8.0	13.0	14.4	99.4	23.6	9.5
	*100.0**	*4.8*	*7.7*	*8.6*	*59.2*	*14.1*	*5.7*
IIQ	476.9	0.7	23.1	60.4	267.3	102.3	23.2
	100.0	*0.1*	*4.8*	*12.7*	*56.0*	*21.5*	*4.9*
IIIQ	404.9	7.1	10.4	25.0	220.4	78.7	63.3
	100.0	*1.8*	*2.6*	*6.2*	*54.4*	*19.4*	*15.6*
IVQ	365.2	6.5	14.0	46.0	177.2	99.1	23.0
	100.0	*1.8*	*3.8*	*12.6*	*48.5*	*27.1*	*6.3*
2001 IQ	381.9	5.2	17.4	23.5	150.9	115.2	69.8
	100.0	*1.4*	*4.6*	*6.2*	*39.5*	*30.2*	*18.3*
In foreign currencies							
2000 IQ	641.3	35.0	60.8	45.8	314.7	148.3	36.8
	100.0	*5.5*	*9.5*	*7.1*	*49.1*	*23.1*	*5.7*
IIQ	765.4	26.2	25.6	48.0	323.5	265.6	77.2
	100.0	*3.4*	*3.3*	*6.3*	*42.3*	*34.6*	*10.1*
IIIQ	650.9	10.5	20.6	49.7	305.8	162.0	102.1
	100.0	*1.6*	*3.2*	*7.6*	*47.0*	*24.9*	*15.7*
IVQ	643.9	2.9	36.5	16.6	213.2	282.8	91.8
	100.0	*0.5*	*5.7*	*2.6*	*33.1*	*43.9*	*14.3*
2001 IQ	705.7	4.8	39.4	44.8	218.8	255.6	142.4
	100.0	*0.7*	*5.6*	*6.3*	*31.0*	*36.2*	*20.2*

* Shares (%) of different maturity loans are given in *Italics*.

of banks to extend long-term loans in foreign currencies is significantly better.

Although it was anticipated that the volume of loans in euro would increase in the wake of re-pegging the litas, this did not happen in the 1st quarter of 2001. In the last quarter of the previous year, the share of loans in US dollars amounted to 57.3% and the share of loans in euro and other EMU currencies – 42.7%. However, in the beginning of this year, the former went up to 73.9%. It is completely rational that market participants are concerned about the current stability of the litas-US dollar exchange rate more than about the exchange rate risk that is going to emerge after the introduction of the new peg. Furthermore, the share of loans in US dollars with over 1-year maturity, i.e. the term of which expires after re-anchoring the litas, was quite impressive and came to 52.9% in the 1st quarter of 2001.

In the discussed period, interest rates on loans in litas rapidly slipped down due to the dimming risks of devaluation and state default and due to the unhurriedly recovering demand for borrowed capital. It is worth noting that in the light of the Baltic States interest rates in Lithuania plunged most significantly. In March, in Estonia long-term loans in the national currency were most expensive, 10.9%. In Lithuania their price reached 10.4%, and in Latvia – 9.6%. The average interest rate of short-term loans in the national currency was 10.6% in Lithuania, 13.1% in Latvia and 7.7% in Estonia. In Lithuania the average interest rate of long-term loans showed a decrease of 1.3 percentage points (p.p.) over a year, and of short-term loans – 3.6 p.p. over a year. The respective changes per annum were a decrease of 2.9 p.p. and an increase of 3.2 p.p. in Latvia and increases of 2.0 p.p. and 0.3 p.p. in Estonia.

In April–May 2001, Lithuanian interest rates on loans in litas continued to fall. In May, the price of loans decelerated most sharply. The average interest rate of all loans plummeted to the record low level of 9.96%. A decrease from 11.19% (in April) to 9.76% (in May) in the average interest rate of 6–12 month loans that are the most popular mainly predetermined the general decline (see Diagram 13.2).

Although the trend of interest rates on time deposits in litas was more ambiguous, its direction was clear. Interest rates were decreasing (see Diagram 13.3). The share of up to 1-month deposits (in total deposits) was huge, and the average interest rate of these deposits was varying. As an outcome, the interest rates of total deposits were fluctuating more than the interest rates of total loans.

Diagram 13.2

Average Interest Rates on Loans in Litas (%)

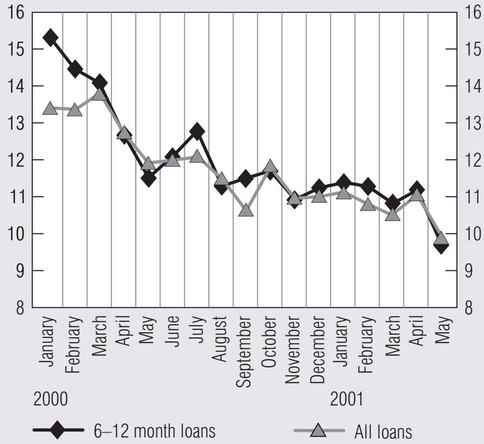
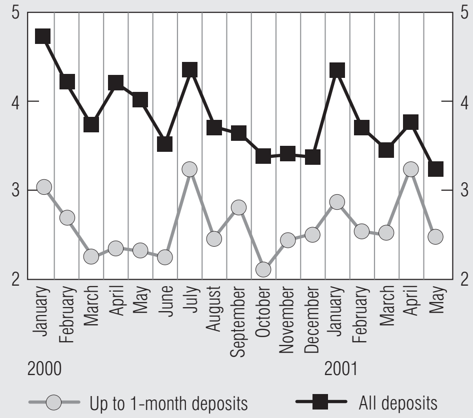


Diagram 13.3

Average Interest Rates on Time Deposits in Litas (%)



13.3. Interbank Market

There were no significant changes in the interbank market during the discussed quarter. As usually, transactions in the national currency dominated the market. Their share constituted 88.0% of all contracts (see Diagram 13.4). The general market activity was similar to the one at the close of last year, but notably swifter than during the first three-quarters of 2000.

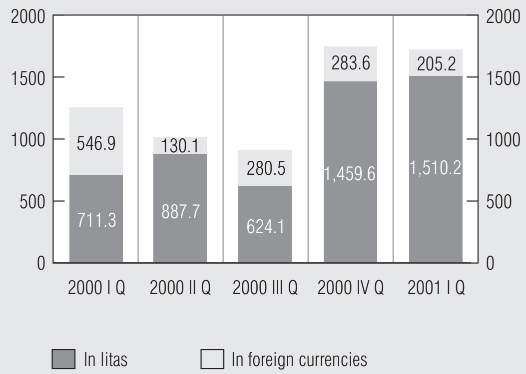
In the structure of interbank transactions the share of 1-day, shortest-term, contracts increased even more (see Table 13.7). Both 1-day contracts in litas and in foreign currencies reached the highest level during the discussed period, while the share of other term contracts became inconsiderable. Banks perceive that the longer-term interbank market is completely illiquid and ineffective as a means for controlling liquidity and currency risk. Therefore they use other instruments (spot, forward and swap operations) for these purposes.

The decision to transfer state treasury accounts from commercial banks (*Lietuvos taupomasis bankas* (*Lithuanian Savings Bank*) in first place) to the *Bank of Lithuania* (BoL) was a significant event in the money market in the reviewed period. The main argument for this decision – to ensure that all commercial banks face the same competitive conditions after Estonian *Hansabank* has bought *Lietuvos taupomasis bankas* (LTB).

The transfer of state treasury accounts from commercial banks to the central bank is going to resolve in larger liquidity fluctuations in the money market. This is related to periodical payments (tax payments, public sector's payroll, etc.). If the state has its treasury accounts with commercial banks, the money circulates only among them (for example, taxes are transferred from payer's "Bank A" to "Bank B" of tax collection accounts). As a result, total liquidity in the banking system varies insignificantly. Short of funds banks may borrow in the interbank market, where liquid reserves are sufficiently available.

Diagram 13.4

Interbank Market Transactions (LTL million)



A bit different situation exists since July 1. After taxes are paid on certain fixed dates, treasury accounts with the BoL will be filled up with large amounts of money. At the same time, commercial banks' liquidity will drain. On the contrary, after payments are made from treasury accounts, the money will go back to commercial banks and enlarge liquidity in the market. During certain periods (on tax collection dates) the situation in the money market may be quite strained, and borrowing possibilities – limited.

If the BoL stays apart from smoothing such liquidity fluctuations, banks (particularly those that usually have to put some efforts to meet the required reserve ratio) may be urged to accumulate excess liquid reserves in order to avoid any risks. Excess reserves do not earn income and thus can have a negative effect on bank profits. It is worth mentioning that so long as the required reserve ratio is high (currently 8%) and serves as a reliable liquidity buffer, the risk of payments crash in the banking sector is quite negligible. Furthermore,

Table 13.7

Interbank Market Transactions (LTL million)

	Total	Of which					
		1 day	2–7 days	8 days– 1 month	1–3 months	3–6 months	Over 6 months
In litas							
2000 IQ	711.3	550.6	106.9	40.2	10.6	3.0	—
	*100.0**	*77.4*	*15.0*	*5.7*	*1.5*	*0.4*	—
IIQ	887.7	631.8	155.7	90.1	10.0	—	—
	100.0	*71.2*	*17.5*	*10.1*	*1.1*	—	—
IIIQ	624.1	462.6	67.0	88.5	6.0	—	—
	100.0	*74.1*	*10.7*	*14.2*	*1.0*	—	—
IVQ	1,459.6	1,057.6	305.6	92.0	0.3	1.7	2.5
	100.0	*72.5*	*20.9*	*6.3*	*0.0*	*0.1*	*0.2*
2001 IQ	1,510.2	1,190.6	247.5	71.6	0.5	—	—
	100.0	*78.8*	*16.4*	*4.7*	*0.0*	—	—
In foreign currencies							
2000 IQ	546.9	482.7	35.2	28.0	—	—	1.0
	100.0	*88.3*	*6.4*	*5.1*	—	—	*0.2*
IIQ	130.1	110.1	18.1	2.0	—	—	—
	100.0	*84.6*	*13.9*	*1.5*	—	—	—
IIIQ	280.5	202.2	36.3	38.0	4.0	—	—
	100.0	*72.1*	*12.9*	*13.5*	*1.4*	—	—
IV	283.5	122.0	136.8	8.2	6.6	3.2	6.7
	100.0	*43.0*	*48.3*	*2.9*	*2.3*	*1.1*	*2.4*
2001 IQ	205.2	192.2	11.3	1.5	—	—	—
	100.0	*93.7*	*5.5*	*0.7*	—	—	—

* Shares (%) of different term interbank transactions are given in *Italics*.

banks may apply to the BoL for an overnight loan (at the moment, such loans are temporarily suspended due to legal problems).

Although the BoL is considering the possibility to alleviate the management of liquid reserves by reverting to open market operations used in 1998–2000 (repo auctions of government securities, auctions of time deposits), the probability of implementing this decision is low.

An analysis of VILIBID and VILIBOR shows that the last three maintenance periods of required reserves (from the 13th of every month to the 12th of the following month) – March–April, April–May and May–June – are characterised by different scenarios of required reserves' management. At the end of the April–May maintenance period, overnight interest rates skyrocketed to the record high level (for example, on May 10th, overnight VILIBID was 8.83% and overnight VILIBOR came to 11.50%). Although information on the liquidity situation of individual banks is not publicly reported, most likely this jump in the interest rates was the outcome of one of the banks facing a problem of meeting the reserve requirement. During other maintenance periods, banks met the reserve requirement in advance; thus, at the close of the periods the interbank interest rates were low (for example, on June 12th, overnight VILIBID was 0.83% and overnight VILIBOR was 2.33%).

13.4. Government Securities

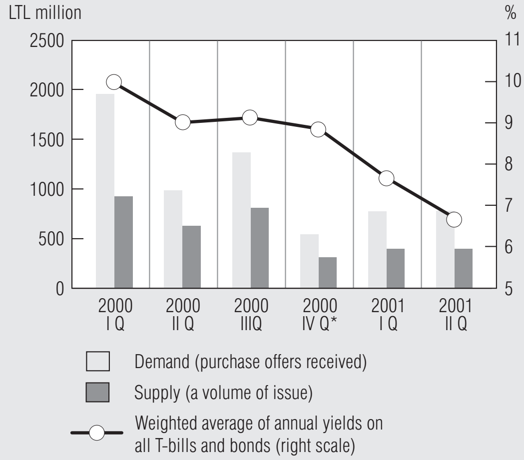
In the first half of this year, there were no surprises in the primary market of government securities. Government securities remained an attractive investment alternative, because fiscal policy continued to be tight, and the state borrowed moderately in the domestic market, which was still characterised by excess liquidity.

As compared to the corresponding period of the previous year, in the first half of 2001, all main indicators of trade in government securities went down. The number of auctions decreased from 37 to 27, the volume of offers to purchase (demand) – from LTL 2,897.2 million to LTL 1,528.2 million (or by 47.3%), the volume of issue (supply) – from LTL 1,525 million to LTL 770 million (by 49.5%), and the sales turnover – from LTL 1,512.6 million to LTL 750.6 million (by 50.4%).

Quarterly data in Diagram 13.5 shows that the 1st and 2nd quarters of this year were very similar in terms of both demand for (LTL 777 million and LTL 751 million, respectively) and supply of (LTL 390 million and LTL 380 million) government securities.

Diagram 13.5

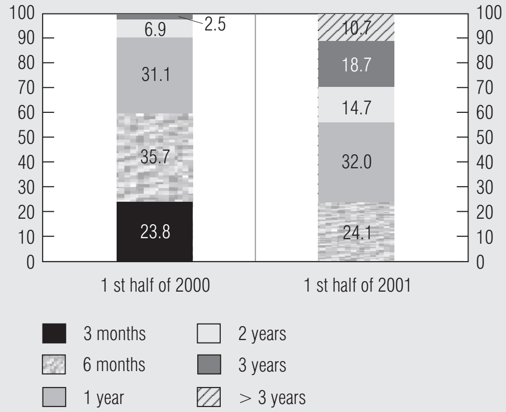
Demand, Supply and Yields on Government Securities in Auctions



* Including 5-year bonds issued in October 2000.

Diagram 13.6

Sales Turnover of Government Securities in Auctions by Maturity (%)



Nevertheless, it should not be concluded that the decreasing volume of trade is exclusively the sign of market's inactivity. Positive developments can be traced as well. In the first half of both 2000 and 2001, the demand to supply ratio was nearly the same, i.e. approximately 2, while the average yield on all government securities kept slipping down. For example, in the 2nd quarter of 2001, it reached the record low level since the beginning of the previous year, 6.6% (see Diagram 13.5). Thus, excess demand for government securities was not the only reason for the decrease in yields. The shrinking country risk contributed on its part.

The increasing average term of borrowing by the government domestically was another robust feature of the market. This strategy of borrowing benefits both the state and market players. The longer maturity of government securities, the cheaper is servicing of state debt, because auctions are organised less often, securities redeemed less often, etc. From the market participants' standpoint, government securities with the maturity of several years is a reliable means to compose and diversify their investment portfolios.

Diagram 13.6 illustrates the restructuring process in the terms of borrowing by the government.

As compared to the corresponding period of the previous year, in the first half of this year, the share of long-term government securities increased at the expense of short-term T-bills. The turnover of bonds went up from LTL 142.6 million to LTL 330 million (or from 9.4% to 44.0% of the total turnover of government securities). On the contrary, the turnover of T-bills decreased from LTL 1,370 million to LTL 420.6 million (or from 90.6% to 56.0%). Although the total number of auctions scaled down, the number of bond auctions rose from 6 to 16, while the number of T-bill auctions fell from 31 to 11.

1-year government securities – T-bills with the longest maturity – were the most popular. Their turnover accounted for LTL 240 million or 32% of the total turnover. In the first half of 2000, the share of 1-year T-bills was nearly the same, 31.1%, but 6-month T-bills were more popular, the turnover of which came to LTL 540 million or 36% of the total turnover.

Although the sales turnover of 2-year bonds grew rather insignificantly, from LTL 105 million in the first half of 2000 to LTL 110 million in the first half of 2001, their share turned up from 6.9% to 14.7%. This is explained by the general decrease in the total turnover. The sales of 3-year bonds increased more notably, from LTL 37.6 million to LTL 140 million or from 2.5% to 18.7% of the total turnover. In the first half of last year, none of bonds with the maturity of over 3 years was traded in auctions. In contrast, from January to June of this year, 5-year and 7-year bonds were successfully sold in four auctions. Bonds with the maturity of 5 years are known for market players since autumn of the previous year. Bonds with the maturity of 7 years were issued this year for first time.

The government probably will have to postpone its ambitious plans to introduce 10-year bonds. Financial markets are very sensitive to changes in the political and economic situation, and there were many of them in Lithuania recently – the government switch, the announced plan of re-pegging the litas, etc. It would be rational to wait for a while and to issue such bonds later, may be already this year.

The tendencies of trade in government securities on the primary market are not likely to change radically in the near future. Although the newly elected leftist Cabinet of Ministers has declared its intentions to follow a socially oriented policy, its financing by increasing state debt is hardly possible. Therefore, neither the issue volume of government securities nor the number of auctions will notably rise. Due to limited supply, the demand for government securities will remain in surplus. Nevertheless, the broadening variety of other financial instruments and the revived process of capital investment will attract capital on their parts and may lessen competitiveness on the primary market of government securities. Obviously, the floor of yields on government securities (the level of US dollar (base currency) interest rates) has not been attained yet, but the room for their decline is quite tight already.

On the secondary market, government securities continued to be quite popular. In the 1st quarter of 2001, the volume of their sales came to LTL 346.0 million or 75.8% of the total National bourse's turnover. The respective figures in the beginning of 2000 were less encouraging, LTL 237.4 million and 73.6%.

In the 1st quarter of 2001, as compared to the 1st quarter of 2000, the share of government securities sold on the secondary market soared from 26.4% to 93.3% of the primary market's turnover. Essentially, this jump is explained by the lower government's need for borrowing and by the decreased primary market's turnover. Nevertheless, the secondary market's turnover increased as well and thus indirectly reflected the improved liquidity of government securities.

The structure of investors in government securities changed insignificantly. At the end of March, investors' holdings amounted to LTL 1,913.6 million and demonstrated an increase of 536.1 million over March of 2000, primarily due to enlarged investments by residents. Like in the past, domestic investors dominated in the government securities market. At the end of the 1st quarter of 2001, the volume of government securities held by domestic players came to LTL 1,893.0 million or 98.9% of the total government securities portfolio. Residents increased their investments in government securities by LTL 534.7 million per annum.

Commercial banks were competing particularly actively in the auctions of government securities. Due to the sluggishly expanding volume of loans, they had quite significant excess reserves. In the discussed period, banks continued to be the largest investors in government securities and improved their relative position even more. The sum of government securities held by banks rose by 70% per annum and accounted for LTL 984.7 million or 51.5% of the total investors' portfolio. Investments by state institutions and municipalities grew even more robustly, from LTL 1.5 million in March 2000 to LTL 178.7 million in March 2001. In contrast, insurance companies decreased their holdings of government securities from LTL 476.3 million to LTL 333.2 million.

Foreigners scarcely increased their portfolio of government securities from LTL 19.3 million to LTL 20.6 million. Investments by Great Britain declined most notably (from LTL 12.5 million to LTL 1.4 million), while Latvian holdings grew from LTL 0.8 million to LTL 5.1 million.

13.5. Stock Exchange

In the beginning of 2001, the *National Stock Exchange of Lithuania* (NSEL) slightly revived. In the 1st quarter of this year, as compared with the respective period of 2000, all main indicators of the NSEL improved. The total NSEL capitalisation went up from LTL 12,581 million to LTL 13,547 million. The number of sessions remained the same, 63, but the total NSEL turnover grew by 41.5% and came to LTL 456.6 million (see Table 13.8). Like in the past, block transactions (over-the-counter market) continued to be the most popular. The turnover of the over-the-counter (OTC) market showed an increase of 31.9% over a year and amounted to LTL 384.4 million. Although trade on the central market remained relatively trivial, the volume of transactions (on the central market) more than doubled, i.e. went up from LTL 31.3 million to LTL 72.2 million.

The demand for debt securities was notably higher than the demand for equities. In the 1st quarter of this year, corporate bonds were not traded, while the turnover of government securities constituted the largest share of the total NSEL turnover (see **Government Securities**). The highest volume of government securities was sold on the OTC market, LTL 316.9 million. Their average turnover per session increased from LTL 3.769 million in the 1st quarter of 2000 to LTL 5.491 million in the 1st quarter of 2001. The predominant turnover of government securities over corporate shares reflected expectations of investors: they preferred fixed income investments (government securities) to corporate shares with fluctuating prices that are hard to predict.

Nevertheless, the turnover of shares soared from LTL 71.3 million in the 1st quarter of 2000 to LTL 110.7 million in the 1st quarter of 2001. The average turnover per

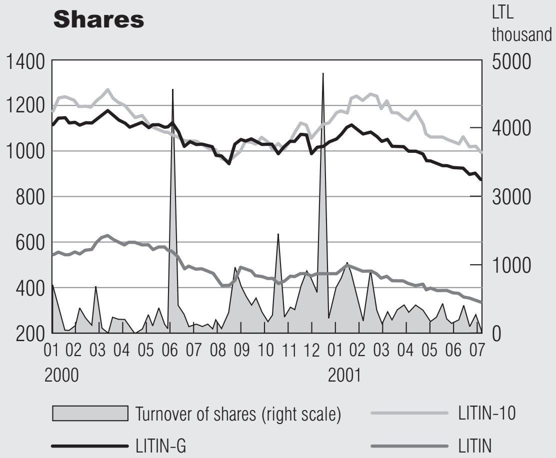
Table 13.8

Main Indicators of the NSEL

Indicators / Period	2000 IQ	2000 IIQ	2000 IIIQ	2000 IVQ	2001 IQ
1. Total NSEL capitalisation (LTL million)	12,581	13,781	13,965	13,741	13,547
2. Total turnover of securities (LTL million):	322.7	367.0	359.1	709.9	456.6
Turnover on the central market	31.3	28.2	28.0	42.2	72.2
Turnover on the OTC market	291.4	338.8	331.1	667.7	384.4
3. Total turnover of shares (LTL million):	71.3	138.1	168.2	431.2	110.7
Turnover on the central market	30.9	27.9	27.5	41.8	43.2
Turnover on the OTC market	40.4	110.2	140.7	389.4	67.5

Diagram 13.7

Price Indices and Turnover of Shares



transaction in shares rose from LTL 6.8 thousand to LTL 8.3 thousand. Trade in shares livened up on both central and OTC markets, by 39.8% and 67.1% respectively.

Diagram 13.7 shows the dynamics of share turnover and price indices.

Different to the indicators of turnovers, changes in price indices were controversial. At the end of the 1st quarter of this year, none of the indices given in Diagram 13.7 reached its respective level of the previous year. It is worth mentioning that starting from the beginning of this year the calculation of the indices is based on the revised methodology (see the previous issue of *Lithuanian Macroeconomic Review*). Therefore, the results of 2000 and 2001 are not purely compatible with each other.

Fluctuations of the indices in the 1st quarter of this year were characterised by some similarities. The LITIN-G index, calculated for all shares quoted on the NSEL, slipped down from 1,042.11 points in the beginning of January to 1,007.28 points at the end of March or by 3.3%. The LITIN index, calculated for Official list's shares, plummeted from 455.88 points to 422.95 points or by 7.2%. In contrast, the LITIN-10 index of ten most liquid shares rose from 1,115.97 points to 1,179.83 points or by 5.7%. At least this segment of the market was somewhat promising.

Unfortunately, in the 2nd quarter of 2001, all of the above mentioned indices scaled down and reflected poor market's liquidity as well as intensifying spirits of the summer season.

Certain signs of bourse's stirring up in the middle of the 1st quarter can be explained by a couple of reasons. At the start of the year, companies released their financial reports for 2000, and speculations on possible dividend payments started. The market welcomed the decision by certain companies to pay dividends. If the company operates successfully and decides to pay dividends, its shares are a robust investment opportunity. Market players promptly responded to the news about favourable annual financial results and dividend payment policies. At the end of March 2001, as compared to the beginning of January 2001, the share price of *Vilniaus Vingis* accelerated from LTL 4.27 to LTL 6.01 (or by 40.7%), *Kalnapilis* – from LTL 3.66 to LTL 4.65 (by 27%) and *Ekranas* – from LTL 6.56 to LTL 8.40 (by 28%).

Furthermore, market participants were attentively following any other information related to corporate activities and their prospects: privatisation news, restructuring of companies, etc. In the discussed quarter, the share price of LISCO went up from LTL 2.06 to LTL 3.68 (or by 78.6%), *Lietuvos dujos* – from LTL 1.26 to LTL 1.55 (by 23%). As an outcome of going-on concentration in the sector of milk products, the shares of *Pieno žvaigždės* and *Žemaitijos pienas* periodically were in the centre of attention.

In the 1st quarter of 2001, net investments (difference between capital inflow and outflow) in securities of Lithuanian companies were positive and reached LTL 120.9 million (see Diagram 13.8). ***This is the largest positive quarterly result since the beginning of 1998 indicating securities market expansion***. In the respective quarter of 2000, net capital inflows were negative (LTL –32.2 million) because of foreigners leaving the market.

This time both domestic and foreign players increased their investments in securities of companies operating in Lithuania. As compared with the 1st quarter of 2000, net capital inflows from residents went up from LTL 11.9 million to LTL 71.5 million or almost 6 times. Gross inflows rose from LTL 129.4 million to LTL 220 million, while outflows – by notably less, from LTL 117.5 million to LTL 148.5 million.

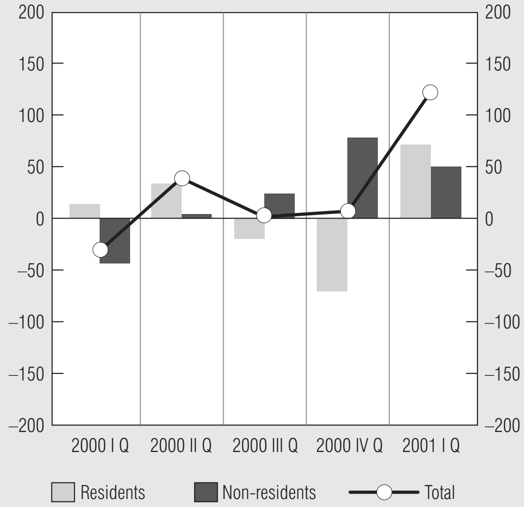
In the 1st quarter of 2000, capital outflows to foreigners exceeded capital inflows from them by LTL 44.1 million. In contrast, in the 1st quarter of this year, non-residents became net investors in securities of Lithuanian companies. Net inflows were positive and came to LTL 49.4 million. Latvia and Germany were the largest holders of Lithuanian securities with respective net investments of LTL 32.5 million and LTL 10.9 million.

In the overviewed quarter of this year, the long-lived tradition of investment in government securities was offended. For the first time since the beginning of last year net inflows for government securities were negative. This can be explained by stringent spending policy of the state and thus the decreased frequency and average volume of new government securities' issues (see **Government Securities**). Negative net investments in government securities (LTL –128.4 million) offset the positive figure of net investments in corporate securities, and the final result of net capital inflows into the NSEL was LTL –7.45 million.

Slowing down businesses during summer and the government switch resulted in quite sluggish trading on the bourse in the middle of the year. Market players are always sensitive to and cautious about political changes, no matter what is the ideological orientation of new ruling powers. Nevertheless, the signs of economic recovery and optimistic news about companies' operations (continued privatisation, strategic agreements in the field of oil refinement, improving financial results,

Diagram 13.8

Net Investments by Residents and Non-residents in Securities of Lithuanian Companies (LTL million)



etc.) are likely to stimulate the NSEL activity in the future. Re-pegging the litas to the euro in the beginning of next year may temporarily freeze the market, but essentially this will have a positive effect on the development of businesses and financial markets. After the currency risk of the litas against the euro is eliminated, capital inflows from the euro zone may grow.

14. State Debt and Budget

In the 1st quarter of 2001, state debt grew by 3.3%, but the ratio of state debt to GDP improved due to more rapid nominal GDP growth (see Table 14.1). It should be noticed that to a certain extent, fluctuations in the exchange rate of the litas and the euro restrained an increase in state debt. At the close of the 1st quarter, the litas showed an appreciation of 5.2% against the euro, as compared to the end of last year. As a result, the share of state debt denominated in euro decreased. The issue of EUR 200 million eurobonds in February was the main reason for the increase in state liabilities.

The government will hardly change the direction of fiscal policy not only this year but also in the next year. Although it is envisaged to facilitate the tax burden in 2002, the government will have to adhere to the agreement with the *International Monetary Fund* (IMF) and adjust its expenditures with potential income. Therefore, the state debt to GDP ratio is expected to be rather stable. After GDP growth makes full speed, the ratio may even go down.

Table 14.2 shows the dynamics of the consolidated central government budget and its components.

The previous issue of *Lithuanian Macroeconomic Review* mentioned that the government had started to decrease its public spending already in the second half of 1999. Unfortunately, in the 1st quarter of 2000, the central government budget was not balanced mainly because of shrinking revenues of the state budget and extra-budgetary funds. For instance, the 1st quarter of 2000, the revenues of the consolidated budget showed a decline of 9.1% over the 4th quarter of 1999.

In the 1st quarter of 2001, the revenues of consolidated central government operations demonstrated an increase of LTL 331.8 million or 12.9% over a year. Both tax and non-tax receivables increased. Since total expenditures remained almost the same as last year, the budget was in surplus (LTL 88.8 million), not in deficit (LTL −416.2 million) as it happened in the respective period of 2000.

The government continued to trim its capital spending, while current expenditures (salaries of the public sector and etc.) declined by only LTL 12.5 million.

The structure of financing the state budget and extra-budgetary funds notably changed. In the 1st quarter of 2000, the government repaid about LTL 600 million of its liabilities to banks operating in the country and turned away from the domestic market. The budget deficit and other financial needs were essentially covered by foreign loans and only insignificantly by non-bank funds. In the 1st quarter of 2001, state's re-

Table 14.1

State Debt in 1998–2001* (%)

Indicators	**Limit**	12 1998	12 1999	06 2000	12 2000	03 2001	05 2001
State debt as a % of GDP**		22.36	28.30	29.02	28.34	27.48	27.40
State foreign debt as a % of GDP		15.67	22.78	22.85	22.04	21.49	21.23
State domestic debt as a % of GDP		6.70	5.51	6.17	6.35	5.99	6.17
State foreign debt as a % of total state debt	**85.00**	70.08	80.49	78.73	77.79	78.22	77.47
State domestic debt as a % of total state debt		29.92	19.51	21.27	22.21	21.78	22.53
Short-term state debt as a % of total state debt	**25.00**	24.47	13.32	12.14	9.04	7.98	8.05

* End-of-period

** GDP in 1998 – LTL 42.990 billion, in 1999 – LTL 42.655 billion, in 2000 – LTL 44.930 billion, forecasted in 2001 – LTL 47.850 billion.

Table 14.2

Consolidated Central Government Operations* in the 1st Quarters of 2000 and 2001 (LTL million)

Indicators	Consolidated state budget		Consolidated extra-budgetary funds		Consolidated social security funds		Consolidated central government operations	
	2000 IQ	2001 IQ	2000 IQ	2001 IQ	2000 IQ	2001 IQ	2000 IQ	2001 IQ
Total revenues and grants	**1,304.7**	**1,646.7**	**192.5**	**147.9**	**1,082.2**	**1,116.6**	**2,579.4**	**2,911.2**
Total revenues	1,304.7	1,646.7	192.5	147.9	1,082.2	1,116.6	2,579.4	2,911.2
Current revenues	1,304.5	1,646.6	180.8	143.6	1,082.2	1,116.6	2,567.6	2,906.8
Tax revenues	1,158.4	1,303.4	124.7	130.4	1,080.1	1,115.3	2,363.3	2,549.1
Non-tax revenues	146.1	343.2	56.1	13.2	2.1	1.3	204.3	357.7
Capital revenues	0.1	0.1	11.7	4.3	—	—	11.8	4.4
Grants	—	—	—	—	—	—	—	—
Total expenditures and lending minus repayments	**1,301.8**	**1,273.5**	**278.6**	**58.7**	**1,415.1**	**1,490.2**	**2,995.6**	**2,822.4**
Total expenditures	1,221.5	1,282.9	327.7	131.9	1,415.1	1,490.2	2,964.3	2,905.0
Current expenditures	1,183.1	1,255.0	229.0	68.6	1,412.6	1,488.6	2,824.7	2,812.2
Capital expenditures	38.4	28.0	98.6	63.3	2.6	1.6	139.6	92.8
Lending minus repayments**	80.3	–9.4	–49.0	–73.2	—	—	31.2	–82.6
Total deficit/surplus	**2.8**	**373.2**	**–86.2**	**89.2**	**–332.9**	**–373.6**	**–416.2**	**88.8**
Financing	**331.9**	**–57.3**	**–42.8**	**–82.2**	**127.1**	**50.7**	**416.2**	**–88.8**
Domestic financing	–564.4	–204.1	–42.8	–82.2	130.4	58.2	–474.8	–228.2
Banks	–689.6	–146.6	–42.8	–82.2	130.4	58.2	–602.0	–170.6
Non-banks	127.2	–57.6	—	—	—	—	127.2	–57.6
Foreign financing	894.3	146.8	—	—	–3.3	–7.5	891.0	139.3

* Table 14.2 shows data on the consolidated state budget, extra-budgetary funds, social security funds, compulsory health insurance funds and the central government budget. Thirteen additional funds were included in extra-budgetary funds starting from January 1, 2001. Data on the consolidated municipal budget is not provided, because not released yet.

** Proceeds from privatisation are interpreted as loan repayments.

Table 14.3

Revenues of the National Budget in January–May 1998–2001 (LTL million)

	1998 I–V	1999 I–V	2000 I–V	2001 I–V
Total revenues	**3,567.7**	**3,563.7**	**3,433.5**	**3,789.6**
Tax revenues	**3,367.9**	**3,355.4**	**3,165.9**	**3,220.9**
Corporate profit tax	270.7	213.3	156.6	140.7
Personal income tax	909.2	1,016.9	990.6	1,018.1
Value added tax (VAT)	1,441.3	1,393.5	1,359.0	1,341.9
Excise duties	481.6	482.1	437.9	483.6
Other taxes	265.1	249.6	221.8	236.6
Non-tax revenues	**199.8**	**185.1**	**245.4**	**342.6**
Other revenues	**—**	**23.2**	**22.2**	**226.1**

liance on the domestic market to finance public spending weakened as well, but not so sharply as it did a year ago. Foreign financing increased quite negligibly.

As it is already mentioned above, in the 1st quarter of 2001, the revenues of central government operations, and the state budget in particular, showed the increase over a year. On the back of which taxes did the revenues go up?

Table 14.3 shows the dynamics of tax collections to the national budget (consisting of state and municipal budgets) in the 5-month period in 1998–2001.

So far, there are no grounds to presume that the collection of taxes radically improved in the 5-month period of 2001. As compared with the previous year, the proceeds from the personal income tax and excise duties went up, but from the corporate profit tax and the value-added tax (VAT) declined. As compared with the respective period of 1999, when the situation in the country was critical, the decreases in the collections of the corporate profit tax and the VAT were quite sharp, while the inflows from the personal income tax and excise duties did not notably change. ***The poor collection of taxes and at the same time the recovering economy lead to the conclusions that the number of companies hiding taxes is growing and the scope of shadow economy is broadening.***

In the first months of this year, the revenues of the national budget rose mainly due to an increase in non-tax and other collections. For example, the profit earned and transferred to the budget by the *Bank of Lithuania* expanded almost three times, from LTL 37.0 million to LTL 98.6 million. Furthermore, the revenues administered by appropriation managers notably increased as well. Since these sources of income are inconsistent, it is hardly possible to rely on them while planning financial flows of the national budget.

APPENDIX

A. Domestic and External Economic Risk Indices

This issue of *Lithuanian Macroeconomic Review* continues to release the domestic economic risk index (DERI) and the external economic risk index (EERI). The number of reported indices' results increases and allows making certain conclusions and comparisons. The DERI and the EERI cannot be less than 1 and greater than 10. The lower the value, the more encouraging is the domestic or external environment.

Latest results of the indices were calculated on the basis of regularly changing economic growth factors.

Diagram A.1 shows the dynamics of the indices in 2000 and the first half of 2001.

Table A.1 shows that the DERI decreased from 4.475 to 4.375. Nevertheless, changes in certain economic factors were controversial. As compared to the previous issue of the publication, the factors of growth in capital investment over last 12 months, expected changes in the consumer demand and access to foreign financing were evaluated more favourably. In contrast, the results of inflation and interest rate factors worsened.

Capital investment started to go up in the 4th quarter of last year and continued to grow in the beginning of this year. Given this fact, the retrospect and forecast of this indicator are more optimistic. Meanwhile the more active process of investment is the main stimulator of consumer demand and domestic markets. Thus, the prospects of the latter are quite good as well. The factor of access to foreign financing are evaluated more favourably because the international agency *Fitch* has revised its long-term foreign currency credit ratings for Lithuania from BB+ to BBB-.

For years to come, inflation is expected to slightly accelerate. Therefore, its grade is revised upwards from 5 to 6. In the beginning of 2001, interest rates on loans in litas fell a bit more, though the room for their decrease is essentially exhausted. In 2001–2002 the process of shrinking interest rates is not going to be of its own accord. The slowly recovering demand for loans will serve as another buffer for a decline in interest rates; this is what happened in Latvia and Estonia in the previous year.

Diagram A.1

Domestic and External Economic Risk Indices

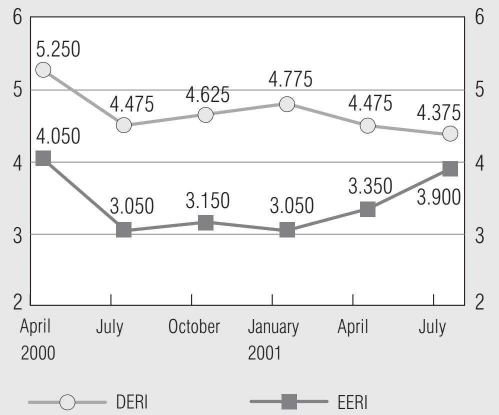


Table A.2 shows changes in the EERI and its components.

As in the previous issue of *Lithuanian Macroeconomic Review*, ***the EERI is revised upward again, this time from 3.35 to 3.90. The revision is based on at least two considerations. First, the US downturn has hit the EU more than expected. Second, the world prices of oil have been fluctuating indeed unpredictably.***

On the other hand, slower economic growth in the euro zone and other countries of Western Europe should not be dramatised. Lithuanian businessmen were able to vigorously increase their exports to this region even in 2000, when the litas and the euro exchange rate was particularly unfavourable (this factor is an urgent issue today as well). The most challenging task for exporters is to re-orient their sales from one to another market (for example, in 1998–1999 after the Russian crisis). If they succeed in penetrating new markets and in establishing stable relationships with their trade partners, losses can be avoided even under complicated conditions.

The factor of oil prices in the world should not be overestimated as well. The experience of last year suggests that the rising world prices of oil have limited influence on consumer and producer prices. The exception is the refined oil industry, but even in this case the higher prices of oil do not automatically mean the weaker competitive position domestically and abroad. The following smoothing factors should not be also overlooked: demand for oil and oil products is quite inelastic in terms of prices; the accelerating prices of oil are a universal phenomenon affecting both Lithuanian businessmen and their competitors, etc.

Table A.1

Domestic Economic Risk Index (DERI)
Internal Economic Environment

	Domestic economic factors	Scale	Weight	Grade	Result	Previous result
1.	Real GDP growth over last 12 months	1 – significant increase 10 – significant decrease	0.05	3	0.15	0.15
2.	Expected real GDP tendencies as compared with the past	1 – notable growth 10 – sharp slow-down	0.1	3	0.30	0.30
3.	Growth in capital investment over last 12 months	1 – significant increase 10 – significant decrease	0.1	5	0.50	0.60
4.	Expected changes in the consumer demand	1 – significant increase 10 – significant decrease	0.05	3	0.15	0.20
5.	Inflation over last 12 months	1 – negligible (zero), supporting economic growth 10 – very high, hampering economic growth	0.05	2	0.10	0.10
6.	Trend in inflation over next 12 months	1 – significant deceleration 10 – significant acceleration	0.05	6	0.30	0.25
7.	Access to foreign financing	1 – readily available 10 – absolutely impossible	0.1	2	0.20	0.30
8.	Availability of labour	1 – ample pool 10 – extreme scarcity	0.025	2	0.05	0.05
9.	Trend in interest rates over next 12 months	1 – sharp decline 10 – significant increase	0.1	4	0.40	0.30
10.	Fiscal policy on spending and borrowing	1 – highly stimulating 10 – tightly restricting economic activities	0.125	9	1.125	1.125
11.	Level of taxes	1 – relatively low 10 – extremely high	0.1	6	0.60	0.60
12.	Trend in the tax level	1 – sharp cut 10 – significant rise	0.05	4	0.20	0.20
13.	Changes in the energy sector over next 12 months	1 – considerable growth 10 – notable recession	0.1	3	0.30	0.30
	Total result		**1**	**52**	**4.375**	**4.475**

Table A.2

External Economic Risk Index (EERI)
External Economic Environment

	External economic factors	Scale	Weight	Grade	Result	Previous result
1.	General economic conditions of the CIS	1 – excellent 10 – serious problems	0.05	5	0.25	0.25
2.	General economic conditions of trade partners in Western Europe and Central and Eastern Europe	1 – excellent 10 – serious problems	0.05	6	0.30	0.25
3.	Prospects of exports to the CIS over next 12 months	1 – notable growth 10 – sharp downturn	0.1	3	0.30	0.30
4.	Prospects of exports to Western Europe and Central and Eastern Europe over next 12 months	1 – notable growth 10 – sharp downturn	0.2	4	0.80	0.60
5.	Trend in foreign trade and the current account balance	1– very positive 10 – very negative	0.2	5	1.00	0.80
6.	Growth in foreign direct investment over next 12 months	1 – significant increase 10 – significant decrease	0.15	3	0.45	0.45
7.	Restrictions on capital mobility	1 – extremely favourable 10 – extremely unfavourable	0.05	2	0.10	0.10
8.	Restrictions on trade	1 – extremely favourable 10 – extremely unfavourable	0.05	2	0.10	0.10
9.	Expectations of litas exchange rate realignment	1 – minimum 10 – maximum	0.1	3	0.30	0.30
10.	Trend in the world oil prices	1 – notable deceleration 10 – considerable acceleration	0.05	6	0.30	0.20
	Total result		**1**	**39**	**3.90**	**3.35**

B. Statistical Tables

Table B.1

Main Foreign Trade Partners of Lithuania* (LTL million)

	Exports			Imports			Balance of foreign trade at f.o.b. prices***	
	2000 IQ	2001 IQ	2001 IQ**	2000 IQ	2001 IQ	2001 IQ**	2000 IQ	2001 IQ
Total	**3,729**	**4,289**	**100.0**	**4,981**	**5,690**	**100.0**	**–11.9**	**–11.5**
European Union	**1,683**	**2,149**	**50.1**	**2,281**	**2,529**	**44.4**	**–12.6**	**–5.6**
Germany	524	636	14.8	752	949	16.7	–15.4	–17.3
Denmark	201	212	4.9	216	225	4.0	–1.2	–0.5
France	185	151	3.5	135	161	2.8	18.1	–0.5
Great Britain	169	538	12.5	306	162	2.8	–26.5	55.5
Sweden	157	169	3.9	154	188	3.3	3.5	–2.8
Holland	159	129	3.0	191	224	3.9	–6.7	–24.5
Italy	88	78	1.8	127	164	2.9	–16.0	–33.2
Central European Free Trade Agreement (CEFTA) Countries	**267**	**281**	**6.6**	**448**	**488**	**8.6**	**–22.8**	**–24.5**
Poland	181	235	5.5	284	344	6.0	–19.6	–16.3
Commonwealth of Independent States (CIS)	**562**	**705**	**16.4**	**1,550**	**1,854**	**32.6**	**–44.8**	**–42.8**
Russia	229	323	7.5	1,377	1,653	29.1	–70.2	–65.9
Ukraine	140	163	3.8	62	68	1.2	40.9	43.4
Belarus	121	165	3.8	76	99	1.7	25.0	27.2
Other countries	**1,218**	**1,153**	**26.9**	**702**	**820**	**14.4**	**29.2**	**19.4**
Latvia	653	652	15.2	194	284	5.0	56.0	41.4
United States	158	182	4.2	82	137	2.4	34.1	16.8
Estonia	70	115	2.7	109	116	2.1	–19.4	2.1

*Data on imports by the country of consignment, provided by *Statistics Lithuania*

**Share (%) in total exports or imports

***As a % in the turnover of trade with a certain country or country group

Table B.2

Exports by Commodity Groups (LTL million)

Commodity groups	Exports					Balance of foreign trade at f.o.b. prices*	
	1998 IQ	1999 IQ	2000 IQ	2001 IQ	Annual change (%), 2001 IQ	2000 IQ	2001 IQ
Total	**3,880.4**	**2,798.7**	**3,729.2**	**4,288.5**	**15.0**	**–11.9**	**–11.5**
Agricultural and food products	524.0	298.9	363.7	436.3	20.0	–11.5	–8.7
Mineral products	784.1	386.7	878.5	1,070.1	21.8	–18.9	–12.4
Chemical products	381.7	329.0	297.1	301.3	1.4	–20.1	–24.3
Plastic, rubber and their products	86.2	63.6	104.4	115.6	10.7	–41.0	–44.6
Wood, paper and their products	247.0	220.2	261.1	292.4	12.0	14.2	11.5
Textile and textile articles	696.1	688.0	730.9	791.3	8.3	26.1	23.8
Metals and their products	146.3	76.5	140.5	161.0	14.6	–20.8	–22.3
Machinery and appliances	433.7	334.1	400.7	454.3	13.4	–23.1	–33.6
Transport equipment	340.6	162.4	243.5	305.2	25.3	–26.5	–18.0
Furniture	93.1	101.4	153.8	185.3	20.5	40.8	41.7
Other goods	147.6	137.9	155.0	175.6	13.3	–35.5	–28.4

* As a % in the turnover of trade in a certain commodity group

Table B.3

Main Indicators of the Balance of Payments (LTL million)
(Analytic table)

Indicators		1998 IQ	1999 IQ	2000 IQ	2001 IQ
A. Current account		**–914.7**	**–750.2**	**–573.4**	**–581.5**
1. Goods (f.o.b. prices)	Exports	4,157.3	3,020.8	3,947.6	4,625.9
	Imports	–5,253.2	–3,943.5	–4,713.1	–5,393.8
Balance on goods		–1,095.9	–922.6	–765.6	–767.9
2. Services	Credit	974.5	909.4	907.5	971.4
	Debit	–747.5	–643.7	–651.4	–571.5
Balance on services		226.9	265.7	256.1	399.9
Balance on services and goods		–869.0	–656.9	–509.5	–368.0
3. Income	Credit	99.3	118.7	162.1	191.5
	Debit	–398.6	–390.5	–468.5	–613.0
Income balance		–299.3	–271.8	–306.4	–421.4
4. Current transfers	Credit	258.7	184.5	245.0	212.6
	Debit	–5.1	–6.0	–2.5	–4.6
Balance on current transfers		253.6	178.5	242.5	208.0
B. Capital account		**0.1**	**–4.7**	**1.8**	**1.7**
	Credit	0.3	4.2	2.2	1.7
	Debit	–0.2	–9.0	–0.4	—
C. Financial account		**1,352.9**	**1,303.3**	**890.8**	**952.7**
1. Direct investment abroad		–4.2	7.0	–13.5	–21.4
2. Direct investment in Lithuania		332.0	422.9	317.2	533.9
3. Investment portfolio abroad		–106.5	–3.8	–99.6	–10.9
4. Investment portfolio in Lithuania		3.5	870.5	859.7	943.7
5. Other investment abroad		527.5	–79.2	–308.0	–1,003.0
6. Other investment in Lithuania		600.6	85.9	135.0	510.4
Balance on current, capital and financial accounts (A + B + C)		**438.3**	**548.4**	**319.2**	**372.9**
D. Errors and omissions		**–93.1**	**–480.8**	**–242.8**	**–600.7**
Total balance of payments (A + B + C + D)		**345.2**	**67.6**	**562.0**	**–227.8**
E. Balance of payments financing		**–342.2**	**–67.6**	**–562.0**	**227.8**
1. Official international reserves		345.2	–67.6	–562.0	227.8
2. IMF loans		—	—	—	—

Table B.4

Main Foreign Direct Investors by Economic Activities in January 2001

	LTL million	%										
	Total	Denmark	Sweden	USA	Germany	Great Britain	Estonia	Finland	Switzerland	Norway	Luxembourg	Other
Total	**9,337**	**18.3**	**17.3**	**9.8**	**7.4**	**6.7**	**6.4**	**6.0**	**4.8**	**4.3**	**3.4**	**15.6**
Mining and quarrying	100	57.6	25.4	0.0	17.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Manufacturing industry	2,686	17.7	10.6	10.7	11.6	6.8	2.4	4.3	12.5	3.8	0.3	19.4
Manufacturing of food, beverages and tobacco products	1,077	19.8	14.5	23.1	2.4	6.1	3.1	2.1	22.6	1.0	0.0	5.4
Manufacturing of textile products	351	0.0	0.3	5.9	29.8	14.5	4.9	11.9	0.0	0.0	0.0	32.6
Manufacturing of wearing apparel; dressing and dyeing of fur	83	41.9	0.4	6.9	10.7	23.8	0.0	0.3	0.2	0.3	0.0	15.5
Manufacturing of wood and wood products (except furniture)	132	7.1	2.4	15.4	18.3	0.3	0.0	0.0	0.0	21.4	0.0	35.0
Manufacturing of pulp, paper and paper products; publishing and printing	101	19.3	64.9	0.9	0.3	0.0	0.0	1.7	0.0	0.0	0.0	12.9
Oil refinement and manufacturing of chemical products	171	18.0	13.9	–16.3*	0.4	0.8	0.3	13.7	0.0	7.1	0.0	62.2
Manufacturing of rubber and plastic product	107	30.7	0.0	0.4	6.3	28.9	0.0	0.0	2.2	0.0	0.0	31.5
Manufacturing of other non-metallic mineral products	150	16.0	17.8	3.0	12.4	0.0	4.8	16.4	0.3	11.3	4.5	13.4
Manufacturing of radio, television and communication equipment and apparatus	129	1.1	0.6	3.1	0.2	0.0	5.3	0.0	67.4	0.3	0.0	22.1
Manufacturing of transport equipment	192	52.7	0.0	0.0	25.5	0.0	0.0	0.0	0.0	16.3	0.0	5.4
Other sub-sectors of the manufacturing industry	192	3.6	4.1	4.8	37.2	7.4	0.1	0.1	0.9	1.6	0.0	40.2
Electricity, gas and water supply	238	0.0	95.6	0.0	0.0	4.2	0.0	0.0	0.0	0.1	0.0	0.0
Wholesale and retail trade; repair of personal and household appliances	2,121	4.4	6.9	12.4	12.0	9.5	2.1	14.8	0.7	10.2	5.3	21.7
Hotels and restaurants	214	1.1	3.2	33.2	2.6	31.7	0.0	0.0	6.7	16.2	0.0	5.4
Transport and storage	175	4.1	20.5	7.8	14.6	17.5	0.9	1.3	0.1	5.9	6.3	21.0
Post and communications	1,577	62.8	16.2	12.0	0.1	0.0	1.1	0.0	0.0	0.0	6.4	1.4
Financial intermediation	1,514	3.3	37.6	0.2	3.3	1.9	28.9	7.4	0.6	0.0	4.6	12.1
Real estate. Renting; Other business activities	489	3.4	8.4	14.3	3.9	19.5	6.3	1.0	12.1	3.6	0.3	27.1
Other economic activities	224	5.5	10.9	8.9	2.6	2.6	0.2	6.4	8.9	6.8	6.1	41.0

* The result is negative due to an incomplete settlement for shares of *Mažeikių nafta* (*Mažeikiai Oil Refinery*) and due to losses suffered by the latter.

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