WORLD BANK OPERATIONS EVALUATION DEPARTMENT

OED REACH

APRIL 28, 2004

Based on the *Lithuania Country Assistance Evaluation.*

Lithuania
Country Assistance Evaluation

- Since 1990 Lithuania has overcome serious structural problems and transitioned successfully to a market economy. Recent GDP growth has been strong, driven by a newly created private sector and close links to EU and other markets. Remaining challenges include addressing unemployment, poverty, and budget and selected sector reforms.
- The Bank was instrumental in supporting the transition with investment and adjustment lending totaling US$491 million since FY93, together with a focused program of economic and sector work. All but one of the Bank's projects have had satisfactory outcomes.
- For the future, if Lithuania requests Bank assistance, including lending, the Bank should focus on areas that complement EU assistance and where the Bank has a comparative advantage. This includes reforms in health, education, pensions, agriculture, and municipal governance.

Background

When Lithuanian independence was regained in 1990, production was almost entirely state-owned and oriented to trade with the countries of the Council for Mutual Economic Assistance. But the population of 3.7 million was well educated, GDP per capita at $2,710 was relatively high, Lithuania's location provided easy access to Western markets, and donors were supportive. Price liberalization was implemented early on. A Currency Board Arrangement was adopted in 1994 and Lithuania has had a good record in adhering to its discipline. Trade reform was vigorously pursued to reorient markets.

Structural reforms were implemented slowly during the first half of the decade, but progress then accelerated, in part motivated by Lithuania's efforts to overcome a banking crisis in 1995/96 and the impact of the Russia crisis in 1998. Macroeconomic and fiscal management in particular has been satisfactory, leading to strong GDP growth and even stronger export growth. Enterprise privatization is now almost complete, all banks are privately owned with substantial foreign participation, the framework for the banking sector is generally satisfactory, the energy sector operates on a largely commercial basis, and important issues in infrastructure are being addressed.

Unemployment, however, has been high, although decreasing from 17 percent in the first quarter of 2002 to 12 percent in the third quarter. Reforms in health, education, and agriculture have lagged, human capital and labor mobility need to be enhanced; and further improvements are needed in the business regulatory environment (especially for small- and medium-scale enterprises). While poverty levels are only about 1 percent according to Millennium Development Goal definitions, they are about 25 percent according to European Union (EU) standards. Pensions now account for 7.2 percent of GDP, almost one-fourth of public sector expenditure. Finally, municipal budgets account for 34 percent of public sector finances, and reforms are required to improve their responsiveness to needs.

EU accession has been an important anchor for Lithuania's reforms since the mid-1990s, with membership expected in May 2004. However, further progress in agriculture is needed for convergence to EU income levels. In the energy sector, the Ignalina nuclear power plant needs to be closed, which will be a substantial burden on the budget.

Bank Assistance

Since FY93, the Bank has lent a total of US$491 million to Lithuania for 17 operations, 49 percent of this for three adjustment operations. As of December 2002, nine loans had closed, of which seven have been evaluated by OED; all but one have had satisfactory outcomes. SAL I achieved almost all of its objectives, including addressing financial sector issues. More recently, Lithuania met most of the conditions of SAL II, which were important in overcoming the macroeconomic problems of 1999 and furthering adjustment in the financial, energy, and other sectors. But two key conditions were not met. One, relating to privatization of the gas company, raises the issue of whether there was adequate broad-based ownership of the reform to warrant Bank intervention in this difficult area, where the Bank considered that it would be in Lithuania's long-term interest to ensure that management of the company could act independently of the gas supplier. The second condition related to ending government price intervention for sugar and grains. Although sugar subsidies still exist, there has been, subsequent to the SAL, a significant reduction in spending on agricultural support mechanisms.

The Bank's program of investment lending in environment, enterprise and financial sector reforms, energy efficiency, and agriculture has also met most of its objectives. The outcome of only one project (agriculture) was rated unsatisfactory, as the Bank-funded line of credit was not competitive with domestic sources of finance, and the project failed to further key aspects of adjustment. In spite of these weaknesses, the overall outcome of the Bank assistance program is rated satisfactory.

Given Lithuania's upcoming membership in the EU, it is likely that the reforms supported by the Bank will be sustained. Lithuania's institutions have been substantially improved and Bank projects have had a high impact on institutional development, particularly in the areas of banking reform, enterprise privatization, and energy.

Recommendations

Lithuania still faces challenges. The key question for the Bank is its future role in post-accession Lithuania. If Lithuania requests Bank assistance, including lending, the Bank should focus on areas that complement EU assistance and where the Bank has a comparative advantage, in particular:

- ***Direct Poverty Reduction and Unemployment***. The Bank should focus on labor market constraints and lack of labor mobility; the business environment; human capital development, including the knowledge economy; unemployment services; and, in *agriculture,* development of a land market.
- ***Health Care***. The Bank needs to build on the early experience of the Health Project to overcome vested interests in the sector and promote further progress.
- ***Municipal Governance***. The Bank needs to sustain and enhance its assistance to promote reforms in this sector.
- ***Pensions.*** The Bank should continue offering technical assistance for pension reform.

Government and Management Response

The Bank's Regional management agreed with the recommendations for future assistance, noting that the Government has explicitly requested that the next CAS be formulated around a non-lending program. The CAS will indicate the lending option, should the Government change its views. The Lithuanian authorities commented on the CAE, noting that Bank support was in most cases well-tailored to Lithuania, although some conditionality was too prescriptive and detailed, and the preparation of some investment lending too slow and insufficiently flexible for a dynamic transitional economy.

Task Manager: Laurie Effron

Senior Manager, OEDCR: R. Kyle Peters • Director: Ajay Chhibber

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