Institut für Höhere Studien (IHS), Wien
Institute for Advanced Studies, Vienna

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Monetary and Exchange Rate Policy in Lithuania

Comparative Analysis

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Abstract

The paper describes Lithuanian monetary and exchange rate developments. Experiences of the other two Baltic states Estonia and Latvia have been analysed as well. New monetary and financial institutions introduced in all Baltic states faced several problems. One was how to maintain the credibility for new fixed exchange rates in order to preserve positive effect on the economy due to the sharp fall of the inflation. The currency board system has been proposed as a reasonable solution. Central Banks of Estonia and Lithuania are operating under the currency board arrangement. The main objective was to keep monetary expansion and inflation under control.

Lithuania undertook several currency reforms. After two year experience of the floating exchange rate, the Lithuanian Government pegged Lithuanian currency to the US dollar in April 1994. From that moment the Lithuanian Central bank has been operating like strict currency board. As an outcome, inflation rates slightly went down and credibility of the Lithuanian currency, the litas, increased.

The paper concludes that under an instability in the transitional economies the Currency Board can serve as an anti-inflationary tool creating convertibility and credibility effects. Moreover, the exchange rate pegging might prevent the government´s inflationary policy.

The period after the reforms in Lithuania and also in Estonia is too short for definitive conclusions. But, from historical point of view the currency board´s arrangements in those countries helped to reach the currency credibility and economic stability to a certain extent.

Keywords

Currency board, Lithuania, transition

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Evidence on Credibility of Exchange Rate and Monetary Policy in The Baltic States

Chapter I. 1.

Introduction

Baltic States' experience shows that countries can disinflate under both pegged and flexible exchange rates. Latvia did the best (by a small margin) on inflation through end of the 1993 while on a flexible rate until February, 1994.

Flexible rate worked reasonably good for Latvia and Lithuania, but this regime was abandoned by Latvia for a peg to SDR's basket. The reason was because of competitiveness problem due to the large appreciation of the Lats from outside capital inflow. The flexible rate was abandoned by Lithuania for the Currency Board because of central bank independence had not been efficient and political pressures had generate high monetary expansion and inflation. Demands from the IMF and the World Bank on a reduction of inflation and currency board introduction. The good performance of the Estonian Currency Board played a significant role.

One of the Baltics' new monetary and financial institutions problem was how to maintain the credibility for new fixed exchange rates. That should be done without starving the economy of the greatly increased real balances. An inflation has fallen sharply in the all three countries. A sudden elimination of inflation through the stabilization means a large increase in the demand for money. If the authorities fail to accommodate this increased demand by increased supply they will cause very high real interest rates. If on the other hand, the authorities increase the supply of money on a large scale the danger is that they will undermine the credibility of the stabilization (Dornbusch and Simonsen, 1988). Held on this dilemma the authorities usually try to take a middle course, with the result that post stabilization real interest rates tend to reflect a mixture of causes: both the overall shortage of liquidity and depreciation and default risk premium. This, however, generates an information and control problem for the authorities, which do not know whether high interest rates mainly reflect liquidity shortage or the lack of credibility of the exchange rate2. The result is that authorities are

2. In which case the nominal money supply should be tightly controlled.

likely to conduct either too restrictive policy leading to an unnecessary recession, or too untied policy, which makes the fixed parity not sustainable and, probably, leads to a re-stimulation of an inflation. A reasonable solution to this problem, however, could be the currency board.

The currency board system was well known in the first half of the century, especially in the former Britain's colonies. An important lesson that can be extracted from different stabilization programs is that reforms must be credible. The concept of credibility could be split into three criteria, which in some authors opinion must all be satisfied to achieve the confidence of economic agents. These three criteria are "transparency", "competence" and "creditor protection".

In this framework, *transparency* means that monetary policy for the transformation process first sets real objectives that can be achieved with policy that is transparently defined. The creation of an institutional arrangement that is as obvious as possible will protect economic agents against unpleasant surprises and build confidence in monetary policy.

Competence can be explained as the proficiency of the central bank to follow the rules that were previously confirmed. Competence can be gained from a country's own national sources or with a foreign aid.

To understand the credibility issue it could be useful to clarify a creditor's definition. In this sense, all representatives who accept central-bank money could be considered as creditors. One essential condition for *creditor protection* is the Central Bank's fair plan to follow the rules that have been laid down.

Every new nation that starts to issue its own currency has the problem of establishing a credibility. Usually there is a hope that future inflation of its currency will be pretty low. (For instance, Poland allowed many formerly subsidized prices to rise to market levels and tied the zloty to the US dollar in crawling peg regime. Yet Polish Central Bank wants credibility. It has already devalued the zloty many times since establishing the link with the dollar. Other East European nations also have long histories of flexing to political pressures for inflation.

The simplest and at the same time the most fixed, is the system in which the money supply placed in circulation by the central bank is backed one hundred percent by gold. Under a gold standard the Litas or Kroon would be clearly defined of specified amount of gold. The central bank would then exchange gold for Litas or Kroon and vice versa at this fixed price on demand. It was the case before the Second World War. The Litas was, therefore, fully convertible into gold. Under such a system, an expansion in the money supply would be linked to an increase in the gold reserves of the Lithuanian Central Bank. Moreover, managed by the gold standard, the Litas/gold ratio would be constant, as the Litas would be interpreted in terms of a particular amount of gold. Therefore it could be concluded that under an instability in the transitional economies the Currency Board is an anti-inflationary tool and creates convertibility and credibility effects. Moreover it exercises hard budget constraints to state owned enterprises which restructuring in the transitional period is very notable.

Chapter I. 2.
Credibility Effects

According to the temporary theoretical approach (Hanke, 1994), a Currency Board system depends entirely on market forces to determine the amount of notes and coins that Board supplies. Market forces also rule the amount of deposits and other components of the money supply. The Currency Board has no independent role in determining the supply of commercial bank reserves in the financial system. The Currency Board's requirements for the commercial banks of one hundred per cent reserve makes these banks only a kind of warehouse for reserves. Since the Currency Board cannot independently influence the amount of reserves, it cannot influence the total supply of credit. Central Bank, in contrast, can independently expand or shrink the amount of reserves available to commercial banks thus stimulating the supply of bank credit, or change the reserves requirements for them. In opposite to anticipation the supply of notes, coins and credit in a currency board system is quite sensitive to changes in demand because reserves can be acquired from the reserve-currency country.

In a currency board system the amount of credit that commercial banks can generate is limited by their ability to maintain sufficient reserves to support that amount of credit. In the orthodox Currency Board any official requirement for the commercial banks to have reserves are exercised. Internal and external competition should stimulate commercial banks to have sufficient reserves for their fully liquidity. Particularly, two

Currency Board countries Hong-Kong and Singapore are the major centers of plentiful, low-cost finance. Currency Board rules just prevent it from creating reserves in an inflationary manner under the circumstances of a current account deficit as the Central Bank can do.

The final reserves in a currency board system are holdings of the reserve currency and/or gold. The one way to acquire new reserves is to purchase them from the reserve-currency country. In uncomplicated form, this requires running the current account surplus or receiving gifts, grants and loans from outside Estonia or Lithuania. A current account surplus increases the supply of domestic money. A current account deficit, on the other hand, decreases the supply of domestic money.

To depict the link between changes in the balance of payments and the domestic money supply under a currency board system very useful could be a flows diagram. A text box one (in the Appendix) begins this analysis. An initial approach is that at the beginning the balance of payments is in balance and exports equals imports. The system is put in motion by generating a balance of payments surplus (via current account surplus). That surplus works its way through a currency board system in the sequence depicted in the text box one.

There are two important details about the adjustment process in an orthodox Currency Board system. The first is that market forces rather than Central Bank action are set in action. The second point could be that because of the fixed exchange rate, arbitrage occurs entirely through changes in the quantity of money, interest rates, and the balance of payments, but not through the exchange rate.

In that respect, the Currency Board system is very similar to the gold exchange standard. A fixed exchange rate between Estonian Kroon or Lithuanian Litas and German mark or US dollar, respectively, should make arbitrage of goods very constricted, if barriers to trade are small. In the long run interest rates should meet at the same point in both countries, besides taxes or understood risk make lending more expensive in one country. Figures on the interest rates for local currency and the convertible currencies time deposits (see Figures 8 and 9) prove that. In the Estonian case it was initially restrained by a law to have deposits in foreign currencies. Therefore, after this limit was taken of (December, 1993) interest rates for foreign convertible currencies were much higher than for the Estonian Kroon. It occurs in quite different way in Lithuania, where from the very beginning economic agents could arrange all financial operations in Litas as well as in foreign convertible currencies. Credibility of Litas, however, is much lower than the reserve currency US dollar. After less than one year under the Law of Credibility of Litas was accepted (the quasi-Currency Board) the interest rates converge quite rapidly (see Tables 12, 13) and achieved almost the same level for the Litas and for the US dollar deposits (or loans). From the other hand it is possible in a currency board system that changes in the money supply could move in a reverse direction from the change in the current account. In that case the balance of payments could be in surpluses because of capital account. There is no reason why the money supply in a modern fractional-reserve banking system should have a fixed relation with the balance of payments, if other factors simultaneously move the money supply in the other direction. Foreign investment is the important factor that can break the rigid relation of the money supply with the current account. For illustration, Honk Kong and Singapore have experienced current account deficits for decades, yet their domestic money supplies have continuously increased because their financial markets attracted large capital inflows of foreign investment (Hanke, 1993). The interest rates give same kind of signaling. Short and long term interest rates have, however, different forecasts. Long time interest rates certainly are not very significant in the Baltics. Majority of commercial banks accept mainly short term time deposits (i.e., no longer than for 12 months.) It happens because of serious uncertainty on the future interest rates. On the other hand depositors have preferences to keep money in commercial banks for shorter periods because of high probability of a bankruptcy of the bank.

There are not any important domestic restrictions on the interest rates in the Baltic States. No restrictions on capital account transactions since 1992. Moreover, commercial banks had sometimes too liberal legislation. Any control was concerned as a residual of the centrally-planned economy times. In the late 1992, there was introduced some limitations concerning exchange offices currency buying and selling differentials. From the other hand, the Independent Baltic States never tried to introduce any regulations on commercial banks' interest rates. Therefore, differences on the local and the foreign convertible currencies interest rates are really good indicators not only for domestic currencies' credibility but either for economical policy efficiency. Data on output and unemployment is not reliable enough and compatible enough across countries to analyze sacrifice ratios. A comparable high degree of hidden unemployment inherited from the centrally planned economy days makes all estimations insignificant. Special emphasis should be put at the confidence that likely to have substantial increases in non-traded goods prices relative to traded goods prices. Data on Lithuanian prices dynamics illustrate that services and local labor force price increased substantially faster. While inflation rates are not very different now Estonia has lowest interest rates and greatest credibility due to Currency Board. Therefore, the time profile on developing credibility could be traced through interest on time deposits rates3 (see Figures 3, 4, 8, 9, 10 and Tables 2, 3, 4, 10, 11, 12, 13)

Chapter I.3.

Comparison of the Lithuanian, Estonian and Latvian situations

Lithuania started with microeconomics transformation in the beginning of 1991, (Using prices liberalization or so called big-bang approach). There was real shock in the summer, 1991, when Russia exercised an economic blockade. Then monthly inflation reached 225 per cent, in the end of 1991. The dependence on the Russia's money supply could not be continued.

Temporary currency, the talonas was introduced in the May, 1992. Moreover a memorandum with the IMF was signed in the Fall, 1992. (Strict constraints on monetary policy and a Macroeconomic stabilization were laid down). Litas (LTL) was introduced into circulation, in June 25, 1993. Initially under the floating exchange rate regime with the high volatility of the exchange rate at the beginning. There were some mistakes exercised by the Lithuanian Central Bank made under the political pressure the Litas was pegged to the US dollar on the April 1st, 1994. Initially, interest rates for the convertible currency deposits and loans increased. Later interest rates for Litas deposits and loans modestly shifted down. Consequently, all interest rates for Litas and US dollar, for deposits and loans converge and decrease.

3. For instance, in Poland, 1989 banks offered very high interest on the zloty deposits because of wish to attract more depositors and to avoid from commotion after the price liberalization. Moreover, majority of Poland citizens were used to save in dollars.

Some Macroeconomic indicators for Lithuania are set out in the Appendix. Until the third quarter of 1993 (monthly averaged 3 percent) inflation was not controlled, compared with 14 percent in the first half. GNP fell by 35 percent in 1992 and a further move downward of over 15 percent occurred in 1993. Government finances on average had a surplus of about 3 percent of GNP over the last five years. The budget position is reduced and unemployment rises from its current low level, the last two years. There likely was a monetary financing of budget deficit. Because of a rigorous incomes policy real wages has fallen of 40 percent in 1992.

The Lithuanian monetary velocity increases quite rapidly. The triple rise of broad money velocity had place between 1991 and 1992, and continued in early 1993. The transitional currency (the talonas, which was planned as an interim currency, and not fully convertible) replaced the rouble in May 1992. It depreciated by over 500 percent against the dollar between its introduction until the May, 1993, when Litas was re-introduced (the temporary nature of the talonas, announced in advance, may also have contributed to this lack of confidence). It then appreciated by about 20 percent, coinciding with a fall in the monthly inflation rate from 25 percent in April to a low point of one percent in August and inflation rose again in the final months of 1993, to over 6 percent.

The Lithuanian monetary policy was at the critical turning point in the mid-1993. A policy of the flexible Litas exchange rate was more attractive because of Lithuanians memories and expectations of strong the Central Bank and the credible pre-war Litas. Dependence on a foreign country's monetary policy was and is under a sharp critique. The next more technical reason was lack of convertible currency and gold reserves for maintaining the fixed exchange rate with the hundred per cent backing. Therefore the floating exchange rate regime was chosen. After one year experience of exchange rate volatility and Lithuanian Central Bank chairs rotation, serious movements to the fixed rate were exercised. The most enthusiastic followers of a fixed exchange rate tendency and the idea of having the Currency Board was the Lithuanian Government, group of industrialists and some other small institutions (e.g. Free Market Institute).

The flexible exchange rate was led by a sharp tightening of monetary policy in the spring, 1993. The Bank of Lithuania announced an increase in the reserve requirements of commercial banks at the central bank including the foreign currency deposits. It auctioned central bank money to meet the liquidity squeeze created by the new reserve requirement, and succeeded in raising interest rates and decreasing an inflation. "It also indicated that it would use the talonas/dollar exchange rate as a short-term indicator of monetary conditions, and adjust interest rates accordingly. This, and the appreciation of the talonas, succeeded in deterring commercial banks from taking large open positions on the currency, a major reason for its earlier weakness" (Melliss, Cornelius, 1994).

On the strength of this improvement in monetary conditions, the Bank of Lithuania decided to go ahead, over a 25 day period from 25 June 1993, with the replacement of the talonas by the fully convertible Litas (the talonas was planned as an interim currency, and not fully convertible). As part of this, the requirement that 25 percent of convertible currency earnings had to be has been removed. Following its introduction the Litas first appreciated from its initial value of 4.5 to the dollar to 2.8 to the dollar in early September. It later dropped back agonizing to 4.3, likely reflecting an apparent easing of monetary policy, an attempt to build reserves by the Bank of Lithuania and more pessimistic views about prospects, especially on trade. From the other hand, this probably reflects a period of rather clean floating. From September 1993 to March 1993, the Litas fluctuated only in the range 3.8 to 4.2 LTL/USD, indicating a targeting of the dollar rate and more active intervention. The Lithuanian Government pegged Lithuanian currency to the US dollar at the exchanged rate 1 dollar to 4 Litas in April 1, 1994. Besides, there was some problem because of the "correct" exchange rate.

According to estimations Litas purchasing power (PP) exchange rate was three and a half Litas for one dollar, when Litas was pegged in 1994. The space left for the future inflation was not so big when exchange rate was fixed at the ratio four Litas to one dollar. In Estonia, at the moment of currency board introduction the Central Bank undervalued Kroon twice. The purchasing power exchange rate was four Estonian kroons to one German mark, but Kroon was pegged at the rate, eight kroons to one German mark. After two years, it seems, that Kroon is overvalued against the German mark because of a higher Kroon inflation rate. From the other hand the main part of inflation is exercised due to the non-traded goods and services prices rise. In majority of former communist ruled countries non-traded commodities officially were total undervalued. From the other hand, it is possible that the exchange rate of the national currency is fixed at a lower level than its purchasing power. Such a step would have a positive effect on the export of goods but would limit imports. The main problem in the Currency Board system arises when monthly inflation level in Lithuania presently diverges from two to four per cent. Under such conditions prices of Lithuanian exported goods would rise in time faster then, for instance, in the United States. Because of the magnified rate of the Litas the home market could be overloaded with cheaper Western goods. Other opinion is that sizable inflation in Baltic States occurs mainly due to the raise in prices of non-traded goods and services.

The following disadvantage could be an extreme cash-to-money ratio, which is very high in the all Baltic countries today. When banking system recovers and gains confidence, there is a room for growth in a broad money supply through the money multiplier. The present exchange rate cannot be labeled as a balanced one because in the future it is a subject to change. According to the opponents of the Currency Board, a real life has not confirmed statements that the model of the Currency Board grants more freedoms to commercial banks and other economic subjects. For example, Estonian legislation concerning the Central Bank gives it the right to liquidate any bank without the necessity of carrying out the legal procedures required in the case of bankruptcy. The question of Central Bank possibility to lend the last resort for such commercial banks are open, too. It depends on the strictness of the Currency Board or according to the last theory how orthodox is the Currency Board.

Eventually, there are two closely linked problems in establishing a Currency Board: the first is choosing of the "right" exchange rate with the evaluation of future inflation. The second is how to obtain the reserves required for the hundred per cent backing of the currency. In the case of Lithuania finding the right level at which to fix the exchange rate is particularly easier than it was in the case of Estonia. Lithuania had two years experience of prices liberalization and floating exchange rate. From the June 25, 1993 when Litas was introduced and since to April 1, 1994 the exchange rate was not fixed.

In Lithuanian financial markets the domestic credit conditions have remained tight since the beginning of 1994. However, there has been a strong preference for liquidity. The share of foreign currency deposits can prove the credibility of Litas, because it is not forbidden to have foreign currency deposits as it was in Estonia. The decreasing gap between interest rates shows level of the Litas credibility compare to the reserve currency. The possibility to have foreign currency deposits in any commercial bank may indicate the growing stability of the Lithuanian banking system.

Since the currency reforms, inflation performance in Lithuania has been reliable. However, interest rates and inflation rates remain much higher than in USA, reflecting the riskiness of the Lithuanian banking system and probability of the reorganization of the Currency Board while inflation convergence is unfinished, it is a symptom of imperfect credibility (from the other hand, a constant competitiveness of traded goods, also bigger productivity growth in the traded goods sector in Lithuania compare to the United States cannot allow the full inflation convergence).

Interest rates for litas and weighted average of interest rate on foreign currencies converge (see Figures 1, 2, 3, 4, 8, 9, 10). But the same happening in Latvia, therefore it is difficult to judge how influential was the Currency Board introduction in Lithuania. Similarities between currency boards arrangements in the former British and French colonies in 1930's and 1950's and nowadays transitional economies are not very acceptable. In the case of colonies they had good established relationships with the former colonizers in political and economical terms. It is too early to make final inferences, but inflation rates slightly went down and credibility of the litas increased.

Estonia5.

The first proposals for a separate Estonian currency appeared still in Gorbachev era, in 1987, though few people could think this may come true soon. After the Bank of Estonia was formally re-established as a central bank, and Estonia achieved independence it became possible to start a currency reform. As it was in Lithuanian case the key driving factor behind the introduction of own currency was emergence of near hyperinflation and a shortage of cash within the Rouble zone. After it was negotiated that new Kroon notes would be ready in the beginning of 1992, and 11.3 tones of gold deposited in the West before the Soviet occupation will be restored to Estonia, it became possible technically to prepare the reform. As the financial pressure increased in May 1992 there

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5. Estonia was the first FSU country which left the Rouble zone.

was no reason for delay. The strategy adopted by Estonia was similar to that adopted by Germany in 1948 and was built on Slovenian experience of 1991, that is a rapid introduction of the new money within a few days, in the contrary to the case of Lithuania when parallel currencies were circulating for a certain period of time. While many experts prefer the first way for it's "clear break with the past", Lithuanian case showed that the other way may work well too. The reasoning behind the second way is usually to avoid public panic.

Estonian citizens who earlier has registered at special conversion points obtained a right to change the 500 cash roubles at a rate of 10 roubles per Kroon between 20th and 22nd of June, 1992. They could convert additional cash roubles at a rate of 50 roubles per Kroon. All roubles on the accounts were converted at a rate of 10 to 1, not having announced the exchange at the beginning, with the exception of amounts over 50000 and 1000000 roubles for physical and legal persons respectively, which had to be checked and approved. The exchange rate was chosen the prevailing one: 10 roubles per Kroon and 8 Kroons per mark. The Kroon was pegged to the DM by the "Law on the Security of the Estonian Kroon" (see Appendix), which prohibited the Bank of Estonia to devalue the Kroon and finance the government and commercial banks. It also stated that the increase in monetary base may not exceed the increase in the Bank of Estonia's foreign reserves. Only a special clause allowing the increase in money base for the well-defined bank rescue operations made the system different from the additional currency board. The Bank of Estonia was divided into Issue Department and Banking Department. The Issue Department operates the currency board: it's assets are the foreign exchange that have to match the liabilities - bank notes and Kroon deposits within the Bank of Estonia. Revenues from seigniorage it passes to the Banking Department, which holds the excess foreign exchange reserves and is responsible for the central banking functions. Combined with initial undervaluation this system ensures credibility, currency convertibility and stability. The Foreign Currency Law did not allow to use foreign currency for domestic transactions, but guaranteed the repatriation of foreign investments and dividends ensuring current account convertibility.

Therefore, Estonian Kroon (EEK) and the Currency Board arrangements were introduced in June 20, 1992. It is the currency board system with 100 percent backing of the currency plus commercial bank deposits at the Bank of Estonia by DEM reserves.

Initially after the currency Board introduction it was forbidden to open foreign currencies deposits, therefore market forces could not define credibility of the Estonian Kroon via interest rates. After the elimination of restrictions in the end of 1993, interest rates for foreign exchange (i.e. for convertible foreign currencies) boosted to the 65 per cent, when interest rates for Kroon deposits stayed very moderate. Moreover if compare with the average annual inflation, interests are negative.

Currency reforms were led by an initial drop of the GNP (by 45 percent) during the first 10 month. Regulations and good interest rates influenced a shift of deposits from hard currency into Kroon. There was a sufficient decrease in inflation (monthly inflation in 1993 averaged to 2 percent, but it remained above the inflation in Germany reflecting, however, the riskiness of the Estonian Banking system and probability of an exchange rate revision)

There are signs of stabilization and growth in Estonia. That stabilization can be sustained in the long term, since for the bank of Estonia is illegal to issue credits for the government. Furthermore, it is too early to conclude but the establishment of an institutional framework also has the principal importance. On the other hand, according to Hanke and co-authors the Central Bank of Estonia "just mimic the Currency Board arrangements ("Currency Board for Russia" S.Hanke, L.Jonung, K.Schuler, 1993). For example, Estonian legislation concerning the Central Bank gives it the right to liquidate any bank without the necessity of carrying out the legal procedures required in the case of bankruptcy.

Latvia, like the other Baltic states has been committed to the introduction of its own currency since it re-obtained independence in the August 1991. Apart of an importance of the independent currency for political reasons, Latvia was dissatisfied with the Russian monetary policy. However, whereas some of the CIS states have objected to Russian policy as being too tight, Latvian authorities view it was too lax. The Latvian authorities saw the monetary reform as a two stage process: in the first stage a "Latvian ruble" was introduced (this was a freely floating, independent, partially internationally convertible currency), in the second stage the Latvian ruble was exchanged for the Lats, which is fully internationally convertible.

Finally, it is important to note that Latvia, in common with most non-Russian successor states has been running a very large balance of trade deficit at world market prices, and that it therefore was subject to a large terms of trade shock once all its trade with the outside world (including the post-Soviet successor states) comes to be conducted at world prices (Hanson, 1992).

On the March 5, 1993 the Latvian national currency was renewed by placing in circulation the first Lats (LVL) note. Latvia chose a floating exchange rate regime. Lats circulated together with Latvian Rouble (a transitional currency) until June 28, 1993, when the regulation came into effect stating that all prices, tariffs and balances of account shall be calculated in Lats. This indicate the completion of the currency reform initiated in 1992. Latvia similarly as Lithuania had introduced a temporary currency, the Latvian Rouble, at approximately the same time as Estonian reform. That was different from Lithuania which applied a very tight monetary policy for the transitory currency. Latvian Rouble steadily appreciated before introduction of Lats, Latvian's pre-war period currency. The Latvian legislation and the policy of the Bank of Latvia ensure free capital flow to and from Latvia. Both foreign currency and Lats can freely enter and leave Latvia, foreign investors are free to repatriate their profits in any currency without any restraint. Although all prices in Latvia have to denominated in national currency - Lats, foreign currencies can be used even for domestic payments, as long as parties involved agree. To ensure free convertibility of Lats, the Bank of Latvia has officially promised to buy and sell any amount of hard currencies to commercial banks at their request (Monetary Review of the Bank of Latvia, vol. 3, 1994). There are some control introduced concerning internal cash flows because of tax collecting problems. Latvian enterprises and companies must declare every month all performed cash transactions worth more than one thousand Lats, say the rules on declaration of cash transactions, approved by the government on May 2, 1995 (Baltic News Service, BNS, May 3, 1995). The flexible exchange rate was rejected by Latvia for the SDR's basket crawling peg because of competitiveness problem due to the large appreciation of Lats from foreign capital inflows. The rate of the SDR was chosen at 0.7997 Lats for 1 SDR, in the February, 1994. After this arrangement appreciation of Lats initially decreased. One US dollar was equal to 0.545 Lats at the end of the third quarter, 1994. Adjusted to the new SDR's, one US dollar was equal to .507 Latvian Lats in the early May, 1995.

Part II.
The Lithuanian Currency Board

Chapter II.1.
Introduction of the Lithuanian Currency Board

On March 17, 1994, the Lithuanian parliament adopted a quasi-currency board arrangement almost identical to the Estonian model (see text of the Law in Appendix). An alternative variant proposed by Steve Hanke, author of several currency board proposals and an adviser to the Lithuanian government, was rejected. Hanke proposed an orthodox currency board: The central bank should be disbanded, the currency board should only back currency, minimum reserve requirements or lender of last resort functions should be ruled out, a majority on the board should be non-Lithuanians, and perhaps the board headquarters should be moved to a foreign country. The political unfeasibility of such an extreme solution is obvious. The proposal was strongly supported by the IMF (IMF Economic Review: Lithuania, 1993) and the Lithuanian Prime Minister (The Baltic Independent, 1994), but strongly opposed by the Bank of Lithuania, by the commercial banks as well as by some industrialists. The law of March 17 is weaker and similar to the Estonian law. Nevertheless the minister of the economy resigned when the law was adopted. Technicalities of the law including rules for borrowing reserves and commercial banks reserve requirements, are still under discussion (the Appendix reveals that). With the implementation of the currency board on April 1, 1994, the Lithuanian government in consultation with Lithuanian Central Bank pegged the litas to the US dollar with exchange rate four litas to one dollar. This was a compromise between the IMF that had favored a rate around 3.8 per dollar and industrial groups that had proposed 4.2 ("The Baltic Independent," April 1, 1994).

The Lithuanian's currency board is only a partial one, "if it is a currency board at all," according to Lithuanian bank experts, and "that is proven even by the name "The Lithuanian Central Bank." Moreover its many targets and instruments are much closer to the Central Bank than to the Currency Board."[1] Nevertheless, so far the Lithuanian

[1] Statement made by author in conversation with bank officials in December 1994.

Central Bank has been operating like strict currency board. There is 100 percent backing of the domestic currency litas and commercial bank deposits at the Bank of Lithuania by US dollars and gold reserves. Access to foreign exchange for litas is available to all through the Currency Board at the fixed rate of four Litas to one dollar. Domestic assets cannot be used to back the Litas liabilities of the central bank. This last feature means that the government must finance any deficit by borrowing from the private sector or commercial banks, but not from the Central Bank. The Lithuanian bank cannot purchase Governmental securities by Law. The seigniorage revenues earned by the Issue Department are passed on Lithuanian Bank and Government (see "Law on the Bank of Lithuania" in Appendix). With respect to the lender of last resort role of the central bank it is allowed to provide loans to the banking system for emergencies, but only up to the limit of its foreign exchange reserves. These accumulated revenues and other sources of the central bank's own capital are available for emergencies2. The Bank of Lithuania does not have a discount window for commercial banks.

In the next section we look more carefully at institutional arrangements on order to evaluate the credibility of the anti-inflationary objective in more details.

Chapter II.2.
The Law on Credibility

The law is shown in Appendix. Careful study of this law shows that there are possibilities for the central bank to change the exchange rate and the money supply in contradiction to rules of a strict currency board. Thus, the credibility of the system is not complete but will depend on a central bank behavior in the initial stages.

One important aspect of the Lithuanian law on Litas Credibility is the power to change the exchange rate. This power lied with the government, in consultation with the central bank, according to article 3. There is a concern that even this may not give the fixed rate sufficient credibility. One possible amendment would be a "double key" system where exchange rate changes would require the approval both of the government

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[2] A bankruptcy of the fifth biggest Lithuanian commercial bank "Aurabank" revealed weakness of the central bank to operate as the lender of the last resort in May 1995

and the central bank. An amendment was accepted in the fall of 1994 where the power to change the exchange rate lies with the central bank in consultation with the government (that was vice versa earlier).

The Lithuanian Bank is a strongly independent one according to the Law as it was even before the Currency Board introduction. The chairperson of the Bank of Lithuania will be appointed for a term of five years by the "Seimas" (Parliament) of the Republic of Lithuania upon the recommendation of the President of the Republic (see "Law on the Bank of Lithuania" in Appendix). This means that government does not have much direct influence on the decisions making in the Central Bank. This situation would enhance credibility of monetary policy, but it is known that leaders of the Lithuanian Central Bank were against an introduction of the currency board. Another important issue for credibility is the ability of the central bank to conduct open market operations influencing the money supply. It is clear from article two of the "Law on the Credibility of Litas" in Appendix. Open market operations cannot be conduct with assets issued by the government. During discussions about "how pure is the currency board" with Lithuanian bank officials, they confirmed that open market operations are not allowed. However, the central bank is able to issue its own securities and use these to conduct open market operations (see article two of this law). Furthermore, room for monetary expansionism is provided by the excess reserves in foreign exchange relative to the litas monetary base when the board began to operate.

There are double balance sheets, one for the pure currency board and other for the excess reserves. This means that there are separate balance sheets for the issue and the banking departments of the central bank. The excess foreign exchange reserves could be used to expand lending to commercial banks. Since the central bank resisted the introduction of the board, these sources of monetary expansionism could undermine the credibility relative to a "strict currency board."

Under the currency board arrangement government should finance its debt by issuing securities to the private sector especially to the commercial banks. The Lithuanian government sector has issued debt this way so far. A first auction of Government securities was held on July 19, 1994. Later an emission of the government treasury bills increased substantially. A problem of placing the supply of the securities may arise when Lithuanian government runs budgets deficits and if must issue more treasure bills. In 1994, the Lithuanian bank held 19 auctions of Government securities. Litas 563.3 million worth of securities (at nominal value) were sold at these auctions (see Table 7). By the end of the year, Government securities from nine emissions have been repurchased. The amount of bills repurchased totaled to 313.4 million litas. Litas 10.2 million were paid on them as interest. At the end of 1994, Government internal debt amounted to almost 250 million Litas (Bulletin of the Bank of Lithuania, vol. 4, 1994).

The issue of Government securities started under the most favorable conditions when interest at commercial banks were decreasing rapidly. Large inflows of foreign currency, the decrease of demand on expensive loans satisfied demand for growth of banks' liquidity. Commercial banks held surplus that increased from 100 million Litas to 200 million Litas during 1993-94, which could have been used purchasing government bills. However, the banks chose to hold these funds on correspondent accounts without any interest. Under the currency board system when the government tries to fund its budget deficit by borrowing from the private sector interest rates on the Treasury bills must increase.

A third way of increasing the money supply in any "strict" currency board is for the government to borrow in international markets. Often the parts of the IMF loans received under the Lithuanian government guarantee are used for rising the foreign exchange reserves3.

A fourth aspect of the Central bank's credibility with respect to monetary policy depends on its ability and willingness to act as a lender of last resort for commercial banks facing liquidity problems. If foreign exchange and gold reserves exceed the monetary base then the Lithuanian Bank has right to be lender of the last resort for commercial banks. The central bank can issue promissory notes to commercial banks, expanding their liquidity (see Article 2). So far there was not any emission of promissory notes, "because of uncertainty in the regulations for this kind of financial means" (from an interview with the deputy chairperson of the Bank of Lithuania). The central bank can provide a limited amount of credit (up to LTL 20 million) to commercial banks that have liquidity problems according to the Law accepted in June 1995. "The ten from the twenty-eight commercial banks in Lithuania have a serious

[3] Statement made by the author from discussion with Lithuanian bank officials in February 1995.

problem with their solvency," according to chairperson of the Bank of Lithuania, "but savings deposited in the bankrupted banks formed only three percents from all deposits in Lithuanian commercial banks" (Weekly "Litas," No 62, August 1995).

While maintaining the monetary base unchanged the Bank of Lithuania can change commercial banks' reserves requirement. A strict currency board, but not an orthodox board has this monetary policy tool available.

According to the Lithuanian Bank authorities, they would exercise rescue operations mainly for large banks, since a large bankruptcy could have a negative impact on all Lithuanian financial markets4.

Commercial banks' fractional reserves should be kept at the Central Bank. Initially, the Bank of Lithuanian had 10 percent fractional reserves' requirement but from the July 1993 it is increased to 12 percent. An unusual matter took place in the very end of 1994, when Lithuanian Central Bank allowed commercial banks to buy Governmental Treasure bills using their own reserves at the Central Bank (Economic review "Vartai" of the daily "Lietuvos Rytas" - "Lithuanian Morning," 1994). Therefore, treasure bills (from 90 to 28 days of maturity) were considered as a part of the fractional commercial bank reserves. More than 17.7 millions of US dollars (Litas 70.8 million) were sold. The reason was that domestic and foreign economic agents withdrew deposit interest at the end of 1994, and sold litas for dollars. Foreign exchange reserves fell USD 17.7 millions. According to the Bulletin of the Bank of Lithuanian (Vol. 1, 1995) the increase of US dollar demand took place because of mass media informal discussions on the litas devaluation. During the fourth quarter of 1994, as whole the Lithuanian bank purchased USD 48.7 million and sold USD 31.4 million5, increasing foreign exchange reserves by USD 17.6 millions. As the result of named transactions USD 240.98 million was sold more then purchased. It shows capital outflows from Lithuania in the end of 1994 (see Figure "Dynamics of Lithuania's Reserves").

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[4] There are few such banks. The main three ones are jointly owned by the State (51 percent of shares) and privately owned banks as the Saving Bank of Lithuania, the Agricultural Bank and the Commercial State Bank.

[5] During the all 1994, the net issue of litas was equal to 577.8 million.

The arrangements designed to create credibility for the Litas are similar to the Estonian Currency Board. The main difference is that the Lithuanian central bank "Lietuvos Bankas" can modify the litas' exchange rate only in a consultation with the Lithuanian government. In Estonian Law the ratio of a fixed exchange rate can be changed only by a decision of Parliament. That Lithuanian rule could be an obstacle for the currency board credibility. Citizens of Lithuania do not put much trust in their parliament nor in the government. The independent and strong central bank or that parts of the central banks which exercise currency board arrangements can be more credible than the central government or even the parliament. Foreign economic agents are looking maybe for a constitutionally proven fixed exchange rate. However, the Currency Board's lack of credibility could be a substantial hindrance for the foreign investment growth and for international capital inflows. The Lithuanian opposition parties have sharply criticized all currency board arrangements, sometimes just because they were introduced by the government of former-communists and collaborationists.

There are disadvantages to the arrangements, however. The frozen foreign exchange reserves held at foreign banks do not help to credit Lithuanian economy. Loans from different foreign institutions are partly used to increase Lithuanian foreign currency reserves. The Lithuanian Government receives these loans with higher interest rates while the Lithuanian reserves are held in foreign banks at lower annual interest rates. All generated differentials should be paid-off from the Lithuanian budget. When profits are earned on the reserves, the interest creates an additional problem: what institution should receive it? The Lithuanian bank uses profits for its reserves' expansion: 50 percent to form the reserve capital and 20 percent to form the authorized capital of the Bank of Lithuania. The remaining profit shall be paid to the budget of the Republic of Lithuania (see "Law on the Bank of Lithuania" in Appendix). Meanwhile many political groups are convinced that more of this profit should be used by the Lithuanian government. This debate proves how unsettled currency board arrangements are. On the other hand, it shows that the Lithuanian Bank is an independent institution.

Rumors inside the Lithuania about the possible devaluation of Litas hurts sharply the still fragile credibility of the local currency. Sometimes it seems like a psychological run on the litas. Lithuanian Government's and Central Bank's officials try to nullify these rumors. "The devaluation of litas is not being considered by the government, or by the central bank, and the issue will not be raised "neither in winter, nor in spring, nor in summer," the Bank of Lithuania's chairperson, Mr. Kazys Ratkevicius, said in February 1995. According to the Law on the Credibility of the Litas, the central bank is not responsible for the inflation rates, therefore its activities are quite simple. "If Lithuania will continue to carry out an economic policy in which the litas will never have to be devalued, it will be an honor for the country, not the bank of Lithuania," the chief banker said ("The Baltic Observer," 1995).

The deputy chairperson of the Lithuanian Central Bank Mr. Jonas Niaura has mentioned that a real life there are very high cost for maintaining the theoretical Currency Board model. There are not enough "pure" market forces that can push toward the international trade and interest rates equilibrium point. Consequently, national governments face delicate policy problems in the small Baltic States, which are very sensitive to the external economical shocks. Dominantly all these shocks come from the former biggest trade partner Russia.

Chapter II. 3 Empirical Evidence

The Currency Board system is quite similar to the gold exchange standard. A fixed exchange rate between Lithuanian litas or Estonian Kroon and US dollar or German's mark, respectively, should make arbitrage of goods and financial assets cheap if barriers to trade are small. In the long run interest rates should meet at the same point in both countries, unless taxes or risk make lending more expensive in a currency board country. Figure 2 shows the interest rates for time deposits in local currency and the convertible currencies, loans rates shown in Figure 3. Estonian case initially was unlike Lithuanian one because of the restrictions by law to have deposits in foreign currencies. After this limit was removed (in the December 1993) starting interest rates for foreign convertible currencies (mainly for German marks) were much higher than for the Estonian Kroon (see Figure "Average Annual Interest Rates on Estonian Commercial Bank Time Deposits"). This situation did not last long, however. In Lithuania from the very beginning agents could arrange all financial operations in litas as well as in foreign convertible currencies (FCC). The interest rates spread shows that the credibility of litas, however, is lower than the credibility of the reserve currency US dollar. After one year under the Law of Credibility of Litas was accepted Lithuanian interest rates converge quite rapidly. They achieved almost the same level for the litas and for the US dollar deposits and loans in the end of 1994, but remained quite stabile during the first half of 1995. After the long discussions on the Litas devaluation and after series of commercial banks bankruptcy6 interest rates slowly went up in the spring 1995. The differential between litas and foreign convertible currencies' interest rates reflects the risk of litas devaluation because of the lack in credibility of Lithuanian currency board (see Figures and Tables "Lithuanian Average Annual Interest Rates").

Before the currency board was set up, litas loan rates followed by small drop in short term rates (less than 12 months) from February to April, 1994, from 93.7 percent to 82.4 percent. There was a drop in long term litas loans (more than 12 months) rates from 63.3 to 39.3 percent from the temporary high level. Interest rates changed very little for the short term foreign convertible currencies (FCC) loans (see Figures and Tables "Lithuanian Average Annual Interest Rates"). There was a substantial fall from 68.3 to 52.1 percent for short term foreign exchange loans. On the other hand, interest rates for long term loans rose from 13.5 to 21.7 percent.

The time deposits rates for litas and foreign exchange can better show alterations of the credibility. There was a quite profuse decline in rates on time deposits during the 1994. For total time deposits rates dropped from 72.6 to 35.4 percent. For litas short term time deposits interest diminished from 64.5 to 39.1 percent. For litas 6-12 months deposits decreased from 72.0 to 41.4 percent. Time deposits rates for foreign convertible currencies went down with some volatility from 25.1 to 9.9 percent after the currency board arrangement was set up. Average monthly interest rates for all time deposits in litas and foreign convertible currencies decreased to the lowest numbers in December, 1994. In September, 1994, the average monthly interest rate for litas time deposits was 3.0 percent, for demand deposits, 1.0 percent. During the third quarter of 1994, time deposits interest rates declined by 36 percent, but for demand deposits remained the same. The highest average monthly interest rates (3.5 percent) were for 6-12 months time deposits, and the lowest rates (2.3 percent) were for time deposits shorter than one month in 1994. The average monthly interest rate for foreign

[6] The nine Lithuanian commercial banks from total 24 bankrupted during 1994 - 1995.

convertible currencies time deposits was 1.7 percent and 0.2 percent for demand deposits, during 1994. Therefore, that were 1.3 and 0.8 points lower than interest rates for litas time and demand deposits, respectively. During the third quarter of 1994 average monthly foreign convertible currencies time deposits interest rates decreased by 19 percent and remained the same for demand deposits.

Average monthly interest rates for foreign convertible currencies time deposits were lower than monthly inflation rate by 2.3 percent. That means that a real monthly interest rate was negative. The highest average monthly interest rates (4.4 percent) were for one month loans, the lowest rates (1.7 percent) were for longer than one year loans during the period after the currency board was set up. Supply of deposits in commercial banks correspondent accounts increased by 21 percent and demand for loans increased only by 13 percent, during the second half of 1994. Therefore, the total wealth in correspondent accounts increased.

In December 1994, average monthly interest rates on total litas time deposits, except deposits for up to one month, as well as on foreign convertible currencies deposits (except fixed for 1-3 months) diminished some more. Average monthly interest rate on litas time and demand deposits figured for 1.6 and 0.6 percent, respectively, in December 1994. The highest average monthly interests on total litas deposits (with the exception of those fixed up for 1-6 months) were observed in January, while the lowest interest rates, except deposits for less than one month, were registered in December during the 1994 (see Tables). Monthly interest on foreign convertible currencies' time deposits have been decreasing since September till the end of the year (see Figure 8). Monthly interest rates (with the exception of deposits fixed for up to one month) were the lowest in December 1994. The decrease of interest rates was for the most part settled by slackened rate of inflation. Average interest rates on both time and demand deposits in litas and foreign convertible currencies have been lower than inflation which was 3.8 percent in December 1994. On the other hand, average monthly interests on litas and foreign exchange loans with maturities under one month and from 6 to 12 months decreased some more. Average monthly interest rates on litas loans accounted for 2.5 percent, and for foreign exchange loans they were 2.8 percent. Named interest rates were by respectively 0.9 and 1.6 percentage point higher than interests on time deposits. Average monthly interest on litas and foreign convertible currencies loans, with the exception of loans with maturities exceeding one year, have been going down since September till end of 1994. In December, the interest on litas loans were the lowest. Average interest rates on all litas and foreign convertible currencies loans have been lower than inflation, in December 1994.

The average monthly interest rate on time deposits in litas was 1.7 percent (annual rate 20.4 percent) in the first quarter of 1995. During the quarter, the interest rate on deposits with the maturity exceeding one year increased (from 1.4 to 2.4 percent), and on deposits with the maturity of 6-12 months decreased (from 2.1 to 1.6 percent).

The average monthly interest rate on time deposits in foreign exchange was 1.4 percent (i.e. annual rate was 16.8 percent). The monthly interest rate on foreign convertible currencies time deposits was 0.3 percentage points less than the rate on time deposits in litas. The nature of this differential shows volatility of the litas credibility of currency board arrangements. The interests on all time deposits, with the exception of deposits with maturity of 1-3 months, grew up. The largest growth of interest rates (from 0.9 to 1.3 percent) was on deposits with the maturity of up to one month, during the first quarter of 1995.

The highest interests (2.4 and 1.9 percent) were on deposits in litas and foreign exchange with maturities exceeding one year. The average monthly interests on all time deposits in litas and on deposits in foreign exchange with the maturities of 6-12 months and over one year were higher than the inflation rate (1.4 percent) in March, 1995. Monthly and yearly data on the total amount exchanged from litas to US dollar and vice versa is an acceptable indicator on the capital movements and floating credibility of the Litas.

The smallest differential in litas and foreign exchange time deposits was 3.8 percents in October 1994, or six months after the currency board introduction. The lowest annual interest rates for litas and foreign exchange time deposits were 19.7 and 14.2 percents, respectively, in December 1994. Lithuanian government started emission of treasure bills offering 30 percent annual interest in the final quarter of 1994. That was an important distortion in the market. Commercial banks prefer to buy government securities rather to supply loans for private sector. As a consequence interest rates went up and, however, credits became more expensive. This point is under a sharp critique from different political groups. On the other hand, government can cover its deficit only issuing debt and borrowing from the public at home or else abroad under the currency board arrangement (see Table 7.). John Williamson (1995, p.20) remarks: "The fact that in tight corner governments have normally preferred to inflate rather than to repudiate their debts suggests that constraining them to repudiate might be costly".

Chapter II. 4. Comparison of Advantages and Disadvantages

Many new states arranged poorly working monetary systems that have not guided to low inflation. Under a such high inflation economies are instable both politically and economically. That was the result of many new nations formed after the First World War. Deficiency of monetary and fiscal discipline caused inflation, which quickly became the critical economic and political problem. Practically many colonies that gained independence after the World War Two have experienced high inflation. On the other hand history provides examples of successful monetary systems that have encouraged rapid economic growth and political equilibrium. Therefore, the Baltic States monetary performance between the Wars remains quite exciting. A study of alternative monetary systems and an image of their historical performance suggests that the Currency Board would be a hopeful option for a small open economy under nowadays situation.

Advantages and disadvantages of the Currency Board were discussed extensively. At the advantage side are these issues. Theoretically transparent and rigid rules for the emission of money are laid down. Therefore the broadly supply of litas corresponds to the current account surpluses or deficits (or put it more simply, to foreign currency bought in a case of surplus and vice versa sold in a situation of deficit at a fixed exchange rate). Government and politicians cannot arrange any pressure on the Central Bank in an attempt to pursue their plans.

Hard budget constraints on the state owned enterprises are exercised. A money supply rise via subsidies line is refused. A fixed rate of the national currency in the terms of the basic foreign currency forms a solid basis for realizing export-import operations. State and local governments loses the chance of borrowing from the Central Bank. This would force them to accelerate a privatization of land and state-run enterprises by attracting local and foreign capital.

The orthodox Currency Board does not regulate commercial banks activities and creates good conditions for competition. Besides, the monetary policies are not decomposed by mistakes made due to the inexperience of bankers. Attracting examples of the Currency Board performances in Hong Kong, Singapore, Estonia gives substantial base for success expectation. It is important, however, to consider an opposite position because some of the proclaimed advantages of the Currency Board are open to criticism.

The next problem of the Currency Board system is that monthly inflation level in Lithuania presently diverges from two to four per cent. Under such conditions prices of Lithuanian exported goods would rise in time faster that say in the United States. Because of the magnified rate of the litas the home market could be overloaded with cheaper Western goods. Other opinion is that sizable inflation in Baltic States occurs mainly due to the raise in prices of non-traded goods and services.

Different lobby groups as industrialists or former "nomenclature" again supported the idea of a flexible exchange rate. It should be realized that revaluation of fixed exchange rate is an extremely dangerous for the credibility of a newly arranged Currency Board, today. Especially it will be depressing in the settlement of foreign investments.

According to the data from the Lithuanian Central Bank, when litas was pegged to the US dollar its purchasing power (PP) exchange rate was three and a half litas for one dollar. The space left for the future inflation was not so big when exchange rate was fixed at ratio four litas to one dollar. In the Estonia, at the moment of currency board introduction CB undervalued Kroon twice. The PP exchange rate was four Estonian Kroon to one German Mark, but Kroon was pegged at the rate eight Estonian Kroon to one German mark. After the two years, it seems, that Kroon is overvalued against the German mark because of a higher Kroon inflation rate. From the other hand the main part of inflation is exercised due to the non-traded goods and services prices rise. It is necessary to take into account that in the all post-communism countries non-traded commodities were deeply undervalued. It is also possible that the exchange rate of the national currency is fixed at a lower level than its purchasing power. Such a step would have a positive effect on the export of goods but would limit imports. The following disadvantage is an elevated cash-to-money ratio, which is very high in Estonia and Lithuania today. When banking system recovers and gains confidence, there is a room for growth in a broad money supply through the money multiplier. Lithuanian Government pegged Lithuanian currency to the US dollar at the exchanged rate one dollar equals to four litas. Besides, there exists a problem of "correct" or "real" exchange rate. The present exchange rate cannot be labeled as a balanced one because in the nearest future it is a subject to change. According to the opponents of the Currency Board, a real life has not confirmed statements that the model of the Currency Board grants more freedoms to commercial banks and other economic subjects. For example, Estonian legislation concerning the Central Bank gives it the right to liquidate any bank without the necessity of carrying out the legal procedures required in the case of bankruptcy. The question of Central Bank possibility to lend the last resort for such commercial banks are open, too. It depends on the strictness of the Currency Board or, according to the last theory, on the strictness of the Currency Board. Eventually, there are two closely linked problems in establishing a Currency Board: the first is choosing of the "real" exchange rate. The second is how to obtain the reserves requiring for the hundred per cent backing of the currency. In the case of Lithuania finding the right level at which to fix the exchange rate is particularly easier than in the case of Estonia. Lithuania had two years experience of prices liberalization and floating exchange rate. From the June 25, 1993 when litas was introduced and since to April 1994 the exchange rate was not fixed.

Part III. Commercial Banking

Chapter III. 1. Structure of Commercial Banks in Lithuania

"During a few-year-long transitional period in the Baltic States all their domestic currencies finally were pegged. Central Banks of Estonia and Lithuania are operating under the currency board arrangement. Latvia officially fixed its exchange rate to the SDR's approximately at the same time as Lithuania introduced its Law on Litas Credibility. Therefore, Central Banks of all these countries have limited possibilities to act as a lender of last resort for local commercial banks.

According to the Estonian and Lithuanian Currency Credibility Law the excess foreign exchange reserves could be used to expand lending to commercial banks. Since the central banks resisted the introduction of the board, these sources of monetary expansionism could undermine the credibility relative to a strict currency board. Authorities of the Lithuanian Bank declared that they would exercise rescue operations mainly for large banks, which bankruptcy could have a negative impact on all Lithuanian financial markets. Nine smaller Lithuanian commercial banks from total 27 bankrupted during 1994 - 1995. These banks are in shadowed boxes in the diagram below .

The Central Banks have a few tools to influence commercial banks activities and, eventually, the money supply in their countries. For instance, while maintaining the monetary base unchanged the Central Bank can change commercial banks' reserve requirement, etc. A relationship between the monetary policy and stabilization of the commercial banking in the subgroup of Baltics transitional economies is certain.

Situation with the Lithuanian commercial banks credit and deposit structure partly is represented in working tables in the Chapter III. 2.. There are twenty seven commercial banks in Lithuania. The structure of the banking arrangements in Lithuania is like this:

The Bank of Lithuania,
2 Branch Offices

Commercial banks

(According to the date of licensing at the Bank of Lithuania)

⇓

Commercial bank "Ukio bankas", 15 branch offices;

⇓

Commercial bank "Ateitis" of Panevezys, 4 representative offices;

⇓

Bank of Cooperation, 29 representative and branch offices;

⇓

Commercial bank "Vilniaus bankas", 12 representative and branch offices;

⇓

Lithuanian Joint-Stock Innovation bank, 30 representative and branch offices;

⇓

"Tauro" bankas, 6 branch offices;

⇓

Litimpeks bankas, 17 representative and branch offices;

⇓

Commercial bank "Balticbank", 1 branch office;

⇓

Commercial bank "Sekundes bankas", no branch offices;

⇓

Bank "Hermis", 12 representative and branch offices;

⇓

Commercial bank "Lietuvos verslas", 6 representative and branch offices;

⇓

Commercial bank "Zemes bankas", no branch offices;

⇓

Bank of Šiauliai, 4 representative offices;

⇓

Joint-stock credit bank "Nida", 2 branch offices;

⇓

Bank "Snoras", 5 representative and branch offices;

⇓

Bank of Commerce and Credit, 1 branch office;

⇓

Commercial joint-stock bank "Lietukis", no branch office;

⇓

Commercial bank "Ancorobank", 6 representative and branch offices;

⇓

Commercial bank "Aurabankas", 1 branch office;

Commercial bank "Kredito bankas", 3 branch offices;

⇓

Commercial bank "Senamiescio bankas", 3 branch offices;

⇓

Commercial Express bank, no branch office;

⇓

Commercial bank "Apus", 4 representative offices;

⇓

The Agriculture Bank, 45 branch offices;

⇓

The Saving Bank, 48 branch offices;

⇓

The State Commercial Bank, 28 branch offices.

Chapter III. 2. Review Of The Consolidated Balance Sheet Of Commercial Banks

By the end of the first Quarter, 1995, the assets of commercial banks totaled to LTL 6204 million. During the quarter, they grew by 6.5 per cent.

Reserves which increased by 2.4 per cent during the quarter accounted for 7.7 per cent of the assets. 89.7 per cent of them were deposits of commercial banks with the Bank of Lithuania. The largest share (89.8%) of the deposits was comprised of restricted deposits (required reserves in litas and foreign exchange) while correspondent accounts made up only 10 per cent. During the quarter, the amount of the funds on the correspondent accounts decreased by 39 per cent, whereas the total of restricted deposits grew by 20.8 per cent. Cash in the cashier's offices of commercial banks declined by more than one third and at the end of March made up 10.3 per cent of the reserves.

Foreign assets accelerated by 9.1 per cent and at the end of March made up 7.1 per cent of the total assets of commercial banks. Claims on non-resident banks accounted for 91 per cent, claims on non-resident non-bank institutions made up 9 per cent, and precious metals accounted for a very small part of foreign assets. Of all the claims on non-resident banks 46.7 per cent were demand deposits, 35.9 per cent were cash and other claims on foreign central banks. During the quarter, claims on non-resident non bank institutions increased considerably, while claims on nonresident banks climbed only by 3.5 per cent.

At the end of March, claims on Central Government made up 1.7 per cent of the assets of commercial banks. During the quarter, they declined considerably. The largest share (81.5"%) of claims on Central Government was made by Treasury bills.

By the end of March, claims on private sector equaled to 54.3 per cent of the assets of commercial banks. They increased by 14.5 per cent during the quarter. Loans to business enterprises accounted for 90.7 per cent, loans to households made up 9.0 per cent, and loans to social institutions were 2 per cent of the claims on private sector. Of all the loans granted in litas and foreign currency by commercial banks to private sector 79.9 per cent were short-term loans and 20.1 per cent were long-term loans. During the quarter, the amount of short-term loans increased by 11.1 per cent, while that of long-term loans by 28.5 per cent. The bulk of the short-term and long-term loans was granted to business enterprises (percentage compared with the total amount of loans; end-of period):

	January	February	March
Short-term loans to:			
Business enterprises	91.0	91.4	91.0
Households	8.8	8.5	8.9
Social institutions	0.2	0.1	0.1
Long-term loans to:			
Business enterprises	79.5	79.8	80.7
Households	9.6	9.8	9.7
Social institutions	10.9	10.4	9.6

Short-term loans granted to business enterprises increased by 11.5 per cent during the quarter, while those to households accelerated by 8.2 per cent. Long-term loans increased by 33.1 and 23.1 per cent, accordingly.

At the end of March, 37.8 per cent of the loans extended to private sector were loans in foreign currencies, 62.2 per cent - loans in litas. During the quarter, foreign currency loans increased by 13.7 per cent, and litas loans grew up by 14.5 per cent. Loans to business enterprises extended in foreign currencies increased by 15.9 per cent while loans to households decreased by 4.5 per cent. Loans in litas accelerated by 14.2 and 23.7 per cent, accordingly.

By the end of first quarter of 1995, claims on non-financial public enterprises accounted for 5.6 per cent of the assets of commercial banks. 88.9 per cent of the named claims were short-term, and 11.1 per cent were long-term loans in litas and foreign currencies. During the quarter, short-term loans decreased by 15.3 per cent whereas long-term loans went up by 6.9 per cent. 17.4 per cent of the loans to non-financial public enterprises were loans in foreign currencies, and 82.6 per cent were loans in litas. During the quarter, loans in foreign currencies decreased by 25 per cent, and loans in litas - by 10.5 per cent.

At the end of Quarter, claims on local authorities and non-bank financial institutions made up a small part of the assets of commercial banks.

Unclassified assets grew by 5.8 per cent and at the end of Quarter equaled to 22.1 per cent of the assets of commercial banks. Fixed assets which increased by 14 per cent, made up the largest part of the unclassified assets (42.6%).

Demand deposits accounted for 19 per cent of the liabilities of commercial banks (they grew by 3.7 per cent). Deposits of private sector made up the largest part of demand deposits *(percentage; compared with the total amount* end-of *period):*

	January	February	March
Demand deposits of:			
Private sector	69.4	68.8	71.6
Non-financial public enterprises	19.6	20.2	18.3
Others	11.0	11.0	10.1

At the end of Quarter, 51.5 per cent of private sector demand deposits were deposits of business enterprises, 43.6 per cent-household deposits, and 4.9 per cent were other funds. During the quarter, demand deposits of non-financial public enterprises increased by 8.8 per cent, those of households grew up by 6 per cent, while demand deposits of business enterprises decreased by 2.9 per cent.

Time and savings deposits as well as deposits in foreign currencies totaled to 33.2 per cent of the liabilities of commercial banks. Foreign currency deposits made up 68.3 per cent, and time and savings deposits made up 31.7 per cent of the total amount. During the quarter, deposits in foreign currencies increased by 19.1 per cent, while time and savings deposits declined by 9.1 per cent. The greatest part of the deposits in foreign currencies belonged to the private sector *(percentage; compared with* the *total amount end-of period):*

	January	February	March
Foreign currency deposits of:			
Private sector	80.2	81.4	84.2
Non-financial public enterprises	19.3	18.0	15.3
Others	0.5	0.6	0.5

At the end of the March , 1995, 69.2 per cent of private sector deposits in foreign currencies were household deposits. Their share increased by 5.6 percentage points during the quarter. The share of deposits of business enterprises decreased by 5.9 percentage points. Household deposits in foreign currencies grew by 42 per cent, deposits of business enterprises climbed by 8.9 per cent, while deposits of non-financial public enterprises decreased by 21 per cent. Private funds made also the largest share of time and savings deposits (percentage; *compared with* the *total* amount; *end-of period):*

	January	February	March
Time and savings deposits of:			
Private sector	85.9	86.1	86.1
Non - financial public enterprises	10.1	8.2	8.8
Others	4.0	5.7	5.1

At the end of the Quarter, 87.1 per cent of the time and savings deposits of private sector were deposits of households, 12.1 per cent were deposits of business enterprises, 0.8 per cent were other funds. During the quarter, time deposits of non-financial public enterprises decreased by 19.8 per cent, deposits of business enterprises by 7.3 per cent, and household deposits -by 7.5 per cent. Foreign liabilities accounted for 7.4 per cent of the liabilities of commercial banks at the end of Quarter. During the quarter, their amount grew by one third. 72.9 per cent of the foreign liabilities were liabilities to non-resident non-bank institutions, 27.1 per cent were liabilities to non-resident banks. Deposits of foreign business companies and individuals accounted for 91 per cent of the liabilities to non-resident non-bank institutions. During the quarter, liabilities to non-resident banks grew by 23.4 per cent, liabilities to non-resident non-bank institutions - by 37 per cent. Deposits of Central Government increased by 7.8 per cent and by the end of The quarter totaled to 5.3 per cent of the liabilities of commercial banks. By the end of The quarter, Government lending funds amounted to 5.8 per cent of the liabilities of commercial banks. During the quarter, they accelerated by 6 per cent. 57.9 per cent of these funds were agricultural funds, 37.5 per cent were other funds, and 4.6 per cent were privatization funds. Agricultural funds increased by 8.9 per cent, other - by 5.7 per cent, while privatization funds declined by 20.1 per cent. The amount of loans of the

Bank of Lithuania decreased by 5.4 per cent and at the end of The quarter made up 2.4 per cent of the liabilities of commercial the end of March, 1995, foreign aid funds and compulsory social security funds made up a small part of the liabilities of commercial banks. During the quarter, the amount of foreign aid funds increased by 14.8 per cent, while the amount of compulsory social insurance funds diminished by 36 per cent. Capital accounts made up 16.9 per cent of the liabilities; their growth during the quarter was 4.9 per cent. Unclassified liabilities went down by 1.0 per cent and at the end of March made up 9.1 per cent of the liabilities of commercial banks.

Consolidated Balance Sheet of Lithuanian Commercial Banks

LTL million; end-of period	1994	1995		
	Dec.	Jan	Feb.	Mar
Reserves	**466.8**	**506.1**	**462.5**	**478.0**
Cash	76.6	69.2	67.6	49.2
Deposits with the LTB	390.1	437.0	394.9	428.8
Free reserves	71.6	81.4	56.3	43.9
Restricted deposits	318.5	355.6	338.6	384.9
Foreign assets	**400.9**	**409.0**	**410.9**	**437.6**
Precious metals	0.10	0.09	0.10	0.10
Claims on non-resident banks	385.0	376.7	365.3	398.3
Claims on non-resident non-banks	15.9	32.3	45.4	39.2
Claims on Central Government	240.8	149.1	106.2	108.4
Claims on local governments	2.0	2.2	2.3	2.5
Claims on non-financial public enterprises	398.6405.8	389.1	345.5	
Claims on private sector	3010.1	3185.8	3341.8	3438.8
Claims on non-monetary financial institutions	9.1	8.0	11.0	21.6
Unclassified assets	1296.9	1352.8	1381.6	1371.6
Total assets	**5825.2**	**6018.9**	**6105.3**	**6204.0**
Demand deposits	**1134.8**	**1162.5**	**1160.5**	**1176.9**
Local governments	100.5	122.6	123.4	111.7
Non-bank financial institutions	6.3	5.0	4.6	6:5

Non-financial public enterprises	198.4		227.7	234.3	215.8
Private sector	829.7		807.4	798.2	842.9
Time and savings deposits	**718.8**		**670.3**	**660.2**	**653.1**
Local governments	0.14		0.18	0.21	1.37
Non-financial institutions		40.1	26.7	37.7	32.0
Non-financial public enterprises	72.1		67.9	54.0	57.8
Private sector	606.6		575.5	568.3	562.0
Foreign currency deposits	**1180.4**		**1277.9**	**1366.8**	**1 406.1**
Local governments	2.9		5.9	6.6	5.7
Non-bank financial institutions	0.21		0.33	0.44	2.30
Non-financial public enterprises	271.4		246.3	246.6	214.5
Private sector	905.9		1025.4	1113.2	1183.6
Foreign liabilities	**344.3**		**398.2**	**398.5**	**457.8**
To non-resident banks	100.7		115.6	120.4	124.2
To non-resident non-banks	243.6		282.6	278.0	333.6
Central Government deposits	304.2		324.1	324.3	327.9
Counterpart funds	28.2		29.6	29.3	32.4
Government lending funds	337.7		334.5	331.3	357.8
Compulsory social security fund	53.4		53.2	40.0	34.2
Credit from the LTB	156.8		158.2	152.3	148.2
Capital accounts	997.5		1032.9	1042.5	1045.9
Unclassified liabilities	569.1		577.4	599.8	563.6
Total liabilities	**5825.2**		**6018.9**	**6105.3**	**6204.0**

IV. Conclusions

The exchange rate pegging can be an useful anti-inflationary mechanism and it stops the government's inflationary policy.

The period after the reforms in Lithuania and even in Estonia is two short to draw definitive conclusions. Eventually, if the supply of liquidity through the capital account is sufficient, interest rates should converge toward those of the German mark. While interest rates may converge toward of reserve country's rates, there is no reason to expect to do same the inflation. Initially, the divergence may be large, reflecting the supercompetitive level of the exchange rate at the time of the currency reform

In the Currency Board system balance of payments, interest rates and money supply are the main adjustment mechanism vs. the floating exchange rate.

A main objective of adopting a currency board in Estonian and Lithuania was to increase domestic currencies and to keep inflation under control. Moreover, government would have to finance any deficit by borrowing from the private sector or commercial banks, but not from the Central Bank under the currency board arrangements. Therefore, governments are issuing debt. The currency board's similar arrangements helped to reach the currency credibility and the economic stability from historical point of view. On the other hand, the period after the reforms in Lithuania and also in Estonia for definitive conclusions is too short.

Effectiveness of the currency board's self balanced management depends on how open is an economy. Currency boards are the most effective in the small and open economies, however.

Deposits and loans interest rates for different currencies are significant signals of the Baltic economies and domestic currencies credibility volatility. After a few years the national currencies are the legal tenders in the Baltics States they obviously achieved higher confidence. That is proved by the lower interest rates and smaller gap between rates for domestic and foreign convertible currencies in Baltics. Eventually, interest rates should converge toward of reserve country's rates. On the other hand, there is an evident lack of capital mobility. Moreover, foreign bank's have legislative obstacles to open their branches in the Baltic States. Governments of Baltic States have intentions to protect local commercial banking system and bankruptcies of which create self-accelerating additional internal shocks.

Inflation rates in the Baltics are much higher than in their reserve currency countries. That could be partially explained by the initial undervaluation of the fixed exchange rates, the productivity bias, the high inherited inflation that has an inertia momentum of its own, the large growth of prices in non-traded goods and services sector, the abnormal distortion of prices for goods and services in the market inherited from centrally-planned economy and the lack of competition allows to exercise monopolistic prices in many fields.

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Eesti Pank Quarterly Review, 1993, 1994

Glossary

ASSETS: total funds, as well as the composition and apportionment thereof. The assets of a bank include cash, securities, loans, real estate, and other property.

BALANCE OF PAYMENTS: a statement of a country's international economic transactions with the rest of the world in terms of value over a particular period of time. The account is based on double entry book-keeping, when each transaction is entered in both debit and credit. Balance of payments is compromised of the whole of standard items, the most common of which are:

Current account, which shows bilateral transactions of trade and services, interests and dividends collected and paid out, and transfers (such as irrevocable transferred valuables and monetary funds, humanitarian aid, etc.);

Capital and Financial Account, which records the transactions of non-residents with non-industrial and non-financial assets, as well as capital transfers.

Reserves, which are made up of gold, foreign currency, and the funds of international financial organizations (e.g. the assets of the International Monetary Fund).

The balance of payments does not actually reflect the amount and state of goods and assets, etc., rather, it shows the financial flows thereof, i.e. changes in said items over a corresponding period of time.

BANK BALANCE SHEET: a statement of indicators which reflects the state of the principle activities of the bank at a given time.

BANK LOAN (CREDIT): commercial confidence which a bank expresses by loaning money for an established period at certain interest rate.

CAPITAL: the value of financial and physical funds.

CAPITALIZATION OF SECURITIES: the emission of securities at market prices.

CASH: metal coin and paper bank-notes.

CENTRAL DEPOSITORY OF SECURITIES: the institution which organizes, executes and controls the accounting of the movement of non-paper (electronic) securities.

CLAIM: a right for the payment or repayment of funds. For example, a right to claim a refund of VAT, income tax, a claim by bank on another for the settlement of interbank indebtedness.

COMMERCIAL BANK: a financial institution which possesses a special license to receive deposits and grant loans.

CONVERTIBLE CURRENCY: a currency which is readily exchangeable for gold or some other foreign currency.

CORRESPONDENT ACCOUNT: an account via which interbank settlements are carried out.

CURRENCY: money of a certain country, including its paper money, coins and deposits; any form of money that serves as a circulating medium and passes from bearer to bearer without endorsement.

DEMAND DEPOSIT: a non-time deposit for which the depositor has the right to require payment of the entire deposit or portion thereof at any time.

DEMAND FOR MONEY: the relationship among incomes, interest rates, and the quantity of money needed to support a given level of economic activity.

DEPOSIT: money which is entrusted to a financial intermediary.

EXCHANGE RATE: the price at which one country's currency can be bought with another currency or gold.

EXPORT: the transportation of goods or capital to another country as well as the provision of services abroad.

IMPORT: the importation of goods or services from another country.

INFLATION: a situation whereby the quantity of money is increasing more rapidly than output. That is, the value of money falls in the general level of prices in the economy of the country.

INTEREST: the price of money; a charge made to the borrower by the lender for the use of money.

INTEREST RATE: a per cent of the principal of an amount borrowed or lent.

LIABILITIES: the whole complex of obligations and commitments. Liabilities of a bank are made up of all kinds of deposits and other financial obligations.

MONETARY AGGREGATES: definitions of money; any group of specific liquid assets (monetary assets), elected to measure money supply.

M1: demand deposits and money in circulation.

M2 (BROAD MONEY): M1 and Quasi money (i.e. demand and time deposits, and money in circulation).

MONEY IN CIRCULATION: the sum of money (coin and bank-notes) which is being held by natural persons and economic entities in a place other than a bank.

MONEY MULTIPLIER: the ratio between money supply and reserve money.

MONETARY STOCK: the aggregate of all kinds of money issued by a government.

MONEY TURNOVER: circulation of money among sectors of economy.

NET DOMESTIC ASSETS: domestic debt minus other items net.

NET FOREIGN ASSETS: foreign assets minus foreign liabilities.

NOMINAL EFFECTIVE EXCHANGE RATE INDEX: an average change of the exchange rate against currencies of the countries which are major foreign trade partners, during a certain period of time.

NON-CONVERTIBLE CURRENCY: a currency that is not readily exchangeable for a generally accepted standard (gold) or some other foreign currency. The exchange rate of non-convertible currency is relatively unstable.

NON-RESIDENTS: legal entities and natural persons who have economic interests in Lithuania but either reside and operate in another country or are residing and operating in the Baltic States for less, than one year, with the exception of embassies, representative offices, military bases, and other similar entities, as well as students who may stay in the country for more than one year.

OFFICIAL RESERVES OF THE BANK OF LITHUANIA are made up of monetary gold and convertible foreign exchange deposited in foreign banks.

PRICE INDEX: the indicator of the change of the purchasing power of money; the price changes during comparative periods of time.

PRIMARY SECURITIES MARKET: the primary and supplementary emission market, in which the spreading of securities takes place among investors.

PROFIT: the difference between total income and total expenses.

PURCHASING POWER OF MONEY: the sum of goods that can be bought for a certain sum of money.

QUASI-MONEY: time deposits of the national currency, convertible currency, or non-convertible foreign currency (evaluated in the national currency).

REAL EFFECTIVE EXCHANGE RATE INDEX: an average change of the exchange rate against currencies of the countries which are major foreign trade partners, during a certain period of time, taking into consideration price changes in each country.

RESIDENTS: legal entities and natural persons who reside in Lithuania permanently or temporarily for a term longer than one year, and operate in the country having economic interests.

SAVINGS: a part of household's (individual's) income that is not spent on current consumption (purchase of goods, services, taxes, etc.). Savings represent a source of loanable funds for financial organizations.

SAVINGS DEPOSIT: an interest-paying account used to safe-keeping and accumulate funds.

SDRs - SPECIAL DRAWING RIGHTS: a new special unit of account, valued in terms of a basket of five currencies (US Dollar, German Mark, French Franc, GB Pound of Sterling and Japanese Yen). Each currency carries the weight that depends on its value. SDRs are an asset held by IMF members as part of their international reserves, but its use is very limited. SDRs may be used to purchase foreign exchange from IMF and serve other specific purposes.

SECONDARY SECURITIES MARKET: the market in which securities which have already been in the primary securities market are circulated. The secondary securities market is made up of organized (Exchange) and unorganized (outside of the Exchange) markets.

SECURITY: the confirmation of the existence of the defined property right and the non-property right which is a subject of public turnover.

SECURITIES CLEARING: clearing between the parties which conclude a deal of debt obligations at the Exchange.

SECURITIES EMISSION: the publishing of a series of securities which grant investors uniform property and non-property rights.

SECURITIES ISSUER: the entity which issues securities on its own behalf.

SECURITIES MARKET: the part of the finance market in which the emission, buying and selling of securities takes place.

SECURITIES RATE: the established buying and selling price of securities at the Exchange.

TIME DEPOSIT: any deposit in a bank account that cannot be withdrawn before a specified date or without advance notice. In the case when the depositor withdraws the money before the specified date, he loses all interest or part of it.

List of Abbreviations

BNS The Baltic News Service

CIS Commonwealth of the Independent States

DEM German mark (Deutsche Mark)

EEK Estonian Kroon

EB The Bank of Estonia

FCC Foreign Convertible Currencies

FSU Former Soviet Union

IMF International Monetary Fund

LTB The Bank of Lithuania

LTL Lithuanian Litas

LVB The Bank of Latvia

LVL Latvian Lats

SDR Special Drawing Right

USD Dollar of the United States

Table 1: DYNAMICS OF THE LITHUANIA'S RESERVES

Data, Month/Year	Total Reserves, millions of US dollar
12/92	**105.9**
1/93	**114**
2/93	**115.9**
3/93	**118.4**
4/93	**118.6**
5/93	**148.7**
6/93	**162.1**
7/93	**239.1**
8/93	**282.9**
9/93	**308.6**
10/93	**334.8**
11/93	**387.2**
12/93	**412.3**
1/94	**408.6**
2/94	**419.2**
3/94	**404.2**
4/94	**463.2**
5/94	**482.4**
6/94	**480.3**
7/94	**494.1**
8/94	**524.3**
9/94	**566.5**
10/94	**605**
11/94	**601.1**
12/94	**587**
1/95	**563**
2/95	**558.4**
3/95	**572.2**
4/95	**584.7**
5/95	**592.9**
6/95	**608.7**

Source: Bulletin of the Bank of Lithuania, 1995.

Table 2: AVERAGE ANNUAL INTEREST RATES ON LITHUANIAN COMMERCIAL BANKS TIME DEPOSITS, LITAS VERSUS FCC DEPOSITS

Date Month/Year	Litas Deposits	FCC Deposits	Differentials
1/93	87.9	N/A	0
2/93	84.3	21.3	63
3/93	75.7	16.2	59.5
4/93	88	20.8	67.2
5/93	100.7	26.3	74.4
6/93	113.2	22.3	90.9
7/93	122.7	19.1	103.6
8/93	77.7	21.4	56.3
9/93	81.3	21.2	60.1
10/93	88.9	28.8	60.1
11/93	82.9	25.8	57.1
12/93	79.9	31.8	48.1
1/94	72.6	31.5	41.1
2/94	64.5	28.5	36
3/94	65.6	29.9	35.7
4/94	60	25.8	34.2
5/94	61.5	29.5	32
6/94	56	25	31
7/94	51.9	29.8	22.1
8/94	49.4	28.8	20.6
9/94	35.4	20.5	14.9
10/94	23.7	19.9	3.8
11/94	22.2	16.8	5.4
12/94	19.7	14.2	5.5
1/95	19.8	15.6	4.2
2/95	20.9	16.3	4.6
3/95	20.2	16.2	4

Source: Bulletin of the Bank of Lithuania, 1995.

Table 3: AVERAGE ANNUAL INTEREST RATES ON LITHUANIAN COMMERCIAL BANKS LOANS, LITAS VERSUS FCC LOANS

Data Month/Year	Loans in Litas	Loans in FCC
1/93	**100.4**	**67.9**
2/93	**91.8**	**65.3**
3/93	**94.5**	**62.8**
4/93	**80.8**	**41.8**
5/93	**93.9**	**66.2**
6/93	**130.7**	**69.8**
7/93	**107.7**	**72.8**
8/93	**71.4**	**66.9**
9/93	**73.8**	**68.7**
10/93	**92.8**	**71.6**
11/93	**76.6**	**69.7**
12/93	**88.3**	**69.2**
1/94	**84.4**	**66.5**
2/94	**84**	**66.6**
3/94	**76.4**	**64.2**
4/94	**72.9**	**56.3**
5/94	**74.5**	**54.1**
6/94	**69.5**	**53.8**
7/94	**69.5**	**59.3**
8/94	**61.3**	**54.4**
9/94	**46.3**	**43**
10/94	**42.6**	**43.9**
11/94	**35.4**	**32.1**
12/94	**29.8**	**33.4**
1/95	**30.3**	**29.4**
2/95	**29.6**	**32**
3/95	**29.1**	**31.5**

Source: Bulletin of the Bank of Lithuania, 1995.

Table 4: AVERAGE ANNUAL INTEREST RATES ON ESTONIAN COMMERCIAL BANKS LOANS, KROON VERSUS FFC LOANS

Date Month/Year	Deposits in Kroon	Deposits in FCC
12/93	12.69	19.6
1/94	11.48	7.5
2/94	12.3	7.2
3/94	11.58	8.67
4/94	11.49	11.4
5/94	12.77	11.21
6/94	12.71	12.83
7/94	12.09	5.2
8/94	10.9	10.37
9/94	11.16	5.51
10/94	-	-
11/94	-	-
12/94	10.1	8.5
1/95		
2/95		
3/95		

Source: Bank of Estonia Information Service, 1995.

Table 5: BALANCE SHEET OF THE CENTRAL BANK OF LITHUANIA (LTB)

Assets of the Lithuanian Central Bank	Liabilities of the Lithuanian Central Bank
Foreign Currency Reserves within Lithuania	Litas notes and coins in circulation
Foreign Currency Reserves in foreign banks	Commercial banks reserves and other current liabilities
Gold Reserves and SDR	Central Government deposits
Unclassified assets	Unclassified liabilities

Table 6: SIMPLIFIED BALANCE SHEET OF LITHUANIAN COMMERCIAL BANK

Assets of the Commercial Bank	Liabilities of the Commercial Bank
Required reserves at the Bank of Lithuania (12 percent of liabilities)	Demand and time deposits
Cash in vaults	Loans from the Bank of Lithuania
Government and other securities	Loans from domestic and foreign commercial banks
Deposits in other commercial banks (foreign and domestic)	Debts to other domestic and foreign economic agents
Loans for domestic and foreign economic agents	

Table 7: SECURITIES OF THE LITHUANIAN GOVERNMENT

Auction date	Bonds maturity, days	Bonds, Litas million			Interest Rate, percent		
		Issue	Demand	Sale by face value	Bid Min	Average	Accepted Max
3 Jan 1995	27	25	15	15	19.5	25.27	27.98
10 Jan 1995	91	50	35.1	35.1	22	26.13	30.00
16 Jan 1995	27	50	54	50	23.65	27.55	30.00
24 Jan 1995	91	35	26.6	26.6	25.95	28.83	32.00
7 Feb 1995	91	30	29.3	29.3	25.00	28.87	35.00
10 Feb 1995	29	50	65.5	50	26.00	28.78	30.50
21 Feb 1995	91	40	23	23	28.99	31.53	36.00
27 Feb 1995	28	45	52.1	45	26.98	29.38	32.00
6 Mar 1995	56	40	18.8	18.8	28.99	32.62	37.98
13 Mar 1995	28	50	62.8	50	27.48	29.28	31.28
21 Mar 1995	28	40	35.1	35.1	28.47	31.42	39.42
27 Mar 1995	28	45	23	20.3	28.08	32.14	36.50

Source: Bulletin of the Bank of Lithuania, 1995.

Table 8: THE BANK OF LATVIA'S EXCHANGE RATE FOR US DOLLAR

MONTH / YEAR	EXCHANGE RATE Lats per US dollar
1/1993	**0.843**
2/1993	**0.819**
3/1993	**0.729**
4/1993	**0.672**
5/1993	**0.662**
6/1993	**0.648**
7/1993	**0.652**
8/1993	**0.639**
9/1993	**0.623**
10/1993	**0.61**
11/1993	**0.609**
12/1993	**0.598**
1/1994	**0.582**
2/1994	**0.573**
3/1994	**0.567**
4/1994	**0.563**
5/1994	**0.565**
6/1994	**0.551**
7/1994	**0.554**
8/1994	**0.552**
9/1994	**0.545**
10/1994	**0.537**
11/1994	**0.548**
12/1994	**0.551**
1/1995	**0.546**
2/1995	**0.541**
3/1995	**0.522**
4/1995	**0.508**
5/1995	**0.508**

Source: Monetary Review of the Bank of Latvia, 1994 - 1995

Table 9: THE BANK OF LITHUANIA'S EXCHANGE RATE FOR US DOLLAR

MONTH / YEAR	EXCHANGE RATE Litas per US dollar
1/1993	**3,91**
2/1993	**4,25**
3/1993	**4,75**
4/1993	**5.14**
5/1993	**5.13**
6/1993	**4.56**
7/1993	**4.26**
8/1993	**4.00**
9/1993	**4.27**
10/1993	**4.06**
11/1993	**3.89**
12/1993	**3.91**
1/1994	**3.9**
2/1994	**3.93**
3/1994	**4.00**
4/1994	**4.00**
5/1994	**4.00**
6/1994	**4.00**
7/1994	**4.00**
8/1994	**4.00**
9/1994	**4.00**
10/1994	**4.00**
11/1994	**4.00**
12/1994	**4.00**
1/1995	**4.00**
2/1995	**4.00**
3/1995	**4.00**
4/1995	**4.00**
5/1995	**4.00**
6/1995	**4.00**

Source: Bulletin of the Bank of Lithuania, 1994-1995

Table 10: LITHUANIAN, LATVIAN AND ESTONIAN AVERAGE ANNUAL INTEREST RATES FOR TIME DEPOSITS IN DOMESTIC CURRENCIES

MONTH / YEAR	LITHUANIAN INTEREST RATES FOR LITAS TIME DEPOSITS	LATVIAN INTEREST RATES FOR LATS TIME DEPOSITS	ESTONIAN INTEREST RATES FOR KROON TIME DEPOSITS
1/1993	87.9	17.9	N/A
2/1993	84.3	29.8	N/A
3/1993	75.7	49.7	N/A
4/1993	88.0	46.6	N/A
5/1993	100.7	34.3	N/A
6/1993	113.2	43.3	N/A
7/1993	122.7	64.6	N/A
8/1993	77.7	18.5	N/A
9/1993	81.3	27.5	N/A
10/1993	88.9	29.9	N/A
11/1993	82.9	25.1	N/A
12/1993	79.9	30.2	12.96
1/1994	72.6	33.3	11.48
2/1994	64.5	50.4	12.3
3/1994	65.6	38.8	11.58
4/1994	60.00	36.00	11.49
5/1994	61.5	28.00	12.77
6/1994	56.00	35.8	12.71
7/1994	51.9	33.7	12.09
8/1994	49.4	33.4	10.9
9/1994	35.4	26.9	11.16
10/1994	23.7	21.3	N/A
11/1994	22.2	23.9	N/A
12/1994	19.7	18.8	10.1
1/1995	19.8	18.4	N/A
2/1995	20.9	16.5	10.4
3/1995	20.2	N/A	N/A
4/1995	20.2	19.9	N/A
5/1995	21.4	19.9	N/A
6/1995	21.5	N/A	N/A

Sources: Bulletin of the Bank of Lithuania, Monetary Review of the Bank of Latvia, Estonian Bank Information Bulletin, 1994 - 1995

Table 11: AVERAGE ANNUAL INTEREST RATES FOR THE TIME DEPOSITS IN FOREIGN CONVERTIBLE CURRENCIES (FCC)

MONTH / YEAR	LATVIAN INTEREST RATES FOR FCC TIME DEPOSITS	LITHUANIAN INTEREST RATES FOR FCC TIME DEPOSITS	ESTONIAN INTEREST RATES FOR FCC TIME DEPOSITS
1/1993	**18.96**	**N/A**	**N/A**
2/1993	**18.5**	**21.3**	**N/A**
3/1993	**19.3**	**16.2**	**N/A**
4/1993	**18.2**	**20.8**	**N/A**
5/1993	**19.2**	**26.3**	**N/A**
6/1993	**16.8**	**22.3**	**N/A**
7/1993	**19.1**	**19.1**	**N/A**
8/1993	**19.8**	**21.4**	**N/A**
9/1993	**17.5**	**21.2**	**N/A**
10/1993	**25.00**	**28.8**	**N/A**
11/1993	**29.1**	**25.8**	**N/A**
12/1993	**26.7**	**31.8**	**19.6**
1/1994	**27.00**	**31.5**	**7.5**
2/1994	**20.9**	**28.5**	**7.2**
3/1994	**22.4**	**29.9**	**8.67**
4/1994	**21.3**	**25.8**	**11.4**
5/1994	**19.1**	**29.4**	**11.21**
6/1994	**17.7**	25.00	**12.83**
7/1994	**18.2**	**29.8**	**5.2**
8/1994	**20.2**	**28.8**	**10.37**
9/1994	**18.4**	**20.5**	**5.51**
10/1994	**16.3**	**19.9**	**N/A**
11/1994	**15.6**	**16.8**	**N/A**
12/1994	**16.5**	**14.2**	**8.5**
1/1995	**16.3**	**15.6**	**N/A**
2/1995	**16.00**	**16.3**	**N/A**
3/1995	**20.2**	**16.2**	**N/A**
4/1995	**17.9**	**16.8**	**N/A**
5/1995	**17.6**	**15.7**	**N/A**
6/1995	**N/A**	**17.5**	**N/A**

Sources: Bulletin of the Bank of Lithuania, Monetary Review of the Bank of Latvia, Estonian Bank Information Bulletin, 1994 - 1995

Table 12: DIFFERENTIALS IN LATVIAN INTEREST RATES FOR THE TIME DEPOSITS IN LATS AND IN FOREIGN CONVERTIBLE CURRENCIES (FCC)

MONTH / YEAR	LATVIAN ANNUAL INTEREST RATES FOR TIME DEPOSITS IN LATS (percent)	LATVIAN ANNUAL INTEREST RATES FOR TIME DEPOSITS IN FCC (percent)	DIFFERENCE BETWEEN INTEREST RATES (percent)
1/1993	**17.9**	**18.96**	**-1.06**
2/1993	**29.8**	**18.5**	**11.3**
3/1993	**49.7**	**19.3**	**30.4**
4/1993	**46.6**	**18.2**	**28.4**
5/1993	**34.3**	**19.2**	**15.1**
6/1993	**43.3**	**16.8**	**26.5**
7/1993	**64.6**	**19.1**	**45.5**
8/1993	**18.5**	**19.8**	**-1.3**
9/1993	**27.5**	**17.5**	**10.0**
10/1993	**29.9**	**25.00**	**4.9**
11/1993	**25.1**	**29.1**	**-4.0**
12/1993	**30.2**	**26.7**	**3.5**
1/1994	**33.3**	**27.00**	**6.3**
2/1994	**50.4**	**20.9**	**29.5**
3/1994	**38.8**	**22.4**	**16.4**
4/1994	**36.00**	**21.3**	**14.7**
5/1994	**28.00**	**19.1**	**8.9**
6/1994	**35.8**	**17.7**	**18.1**
7/1994	**33.7**	**18.2**	**15.5**
8/1994	**33.4**	**20.2**	**13.2**
9/1994	**26.9**	**18.4**	**8.5**
10/1994	**21.3**	**16.3**	**5.0**
11/1994	**23.9**	**15.6**	**8.3**
12/1994	**18.8**	**16.5**	**2.3**
1/1995	**18.4**	**16.3**	**2.1**
2/1995	**16.5**	**16.00**	**0.5**
3/1995	**N/A**	**20.2**	**N/A**
4/1995	**19.9**	**17.9**	**2.0**
5/1995	**19.9**	**17.6**	**2.3**

Source: Monetary Review of the Bank of Latvia, 1994 - 1995

Table 13: DIFFERENTIALS IN LITHUANIAN INTEREST RATES FOR THE TIME DEPOSITS IN LITAS AND IN FOREIGN CONVERTIBLE CURRENCIES (FCC)

MONTH / YEAR	Litas Deposits	FCC deposits	Differentials
1/1993	87.9	N/A	0
2/1993	84.3	21.3	63
3/1993	75.7	16.2	59.5
4/1993	88	20.8	67.2
5/1993	100.7	26.3	74.4
6/1993	113.2	22.3	90.9
7/1993	122.7	19.1	103.6
8/1993	77.7	21.4	56.3
9/1993	81.3	21.2	60.1
10/1993	88.9	28.8	60.1
11/1993	82.9	25.8	57.1
12/1993	79.9	31.8	48.1
1/1994	72.6	31.5	41.1
2/1994	64.5	28.5	36
3/1994	65.6	29.9	35.7
4/1994	60	25.8	34.2
5/1994	61.5	29.5	32
6/1994	56	25	31
7/1994	51.9	29.8	22.1
8/1994	49.4	28.8	20.6
9/1994	35.4	20.5	14.9
10/1994	23.7	19.9	3.8
11/1994	22.2	16.8	5.4
12/1994	19.7	14.2	5.5
1/1995	19.8	15.6	4.2
2/1995	20.9	16.3	4.6
3/1995	20.2	16.2	4.0
/1995	20.2	16.8	3.4
5/1995	21.4	15.7	5.7
6/1995	21.5	17.5	4.0

Sources: Bulletin of the Bank of Lithuania, 1994 - 1995.

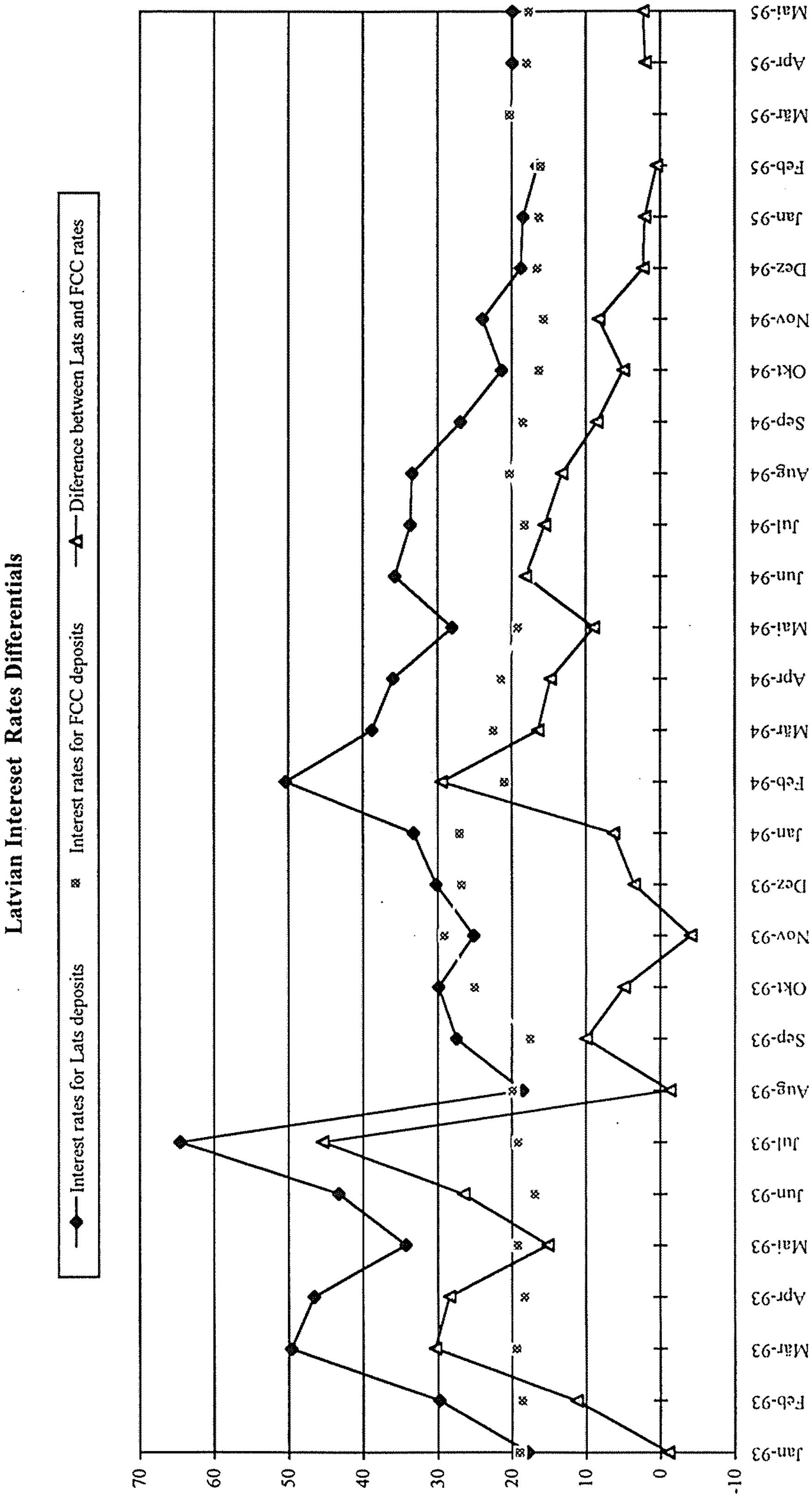


Figure 1. Differentials on Time Deposit Interest Rates in Latvia.

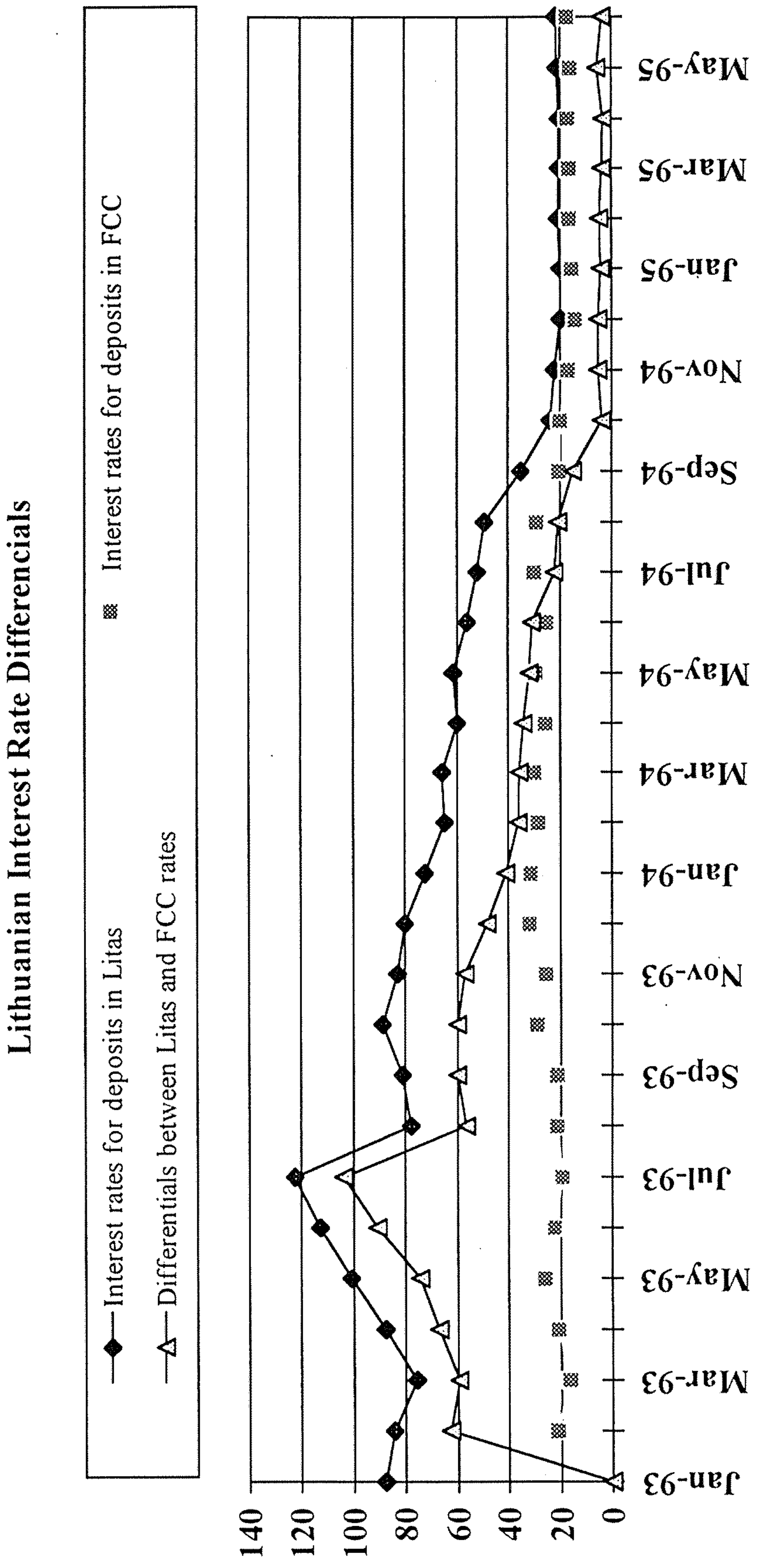


Figure 2. Differentials on Time Deposit Interest Rates in Lithuania.

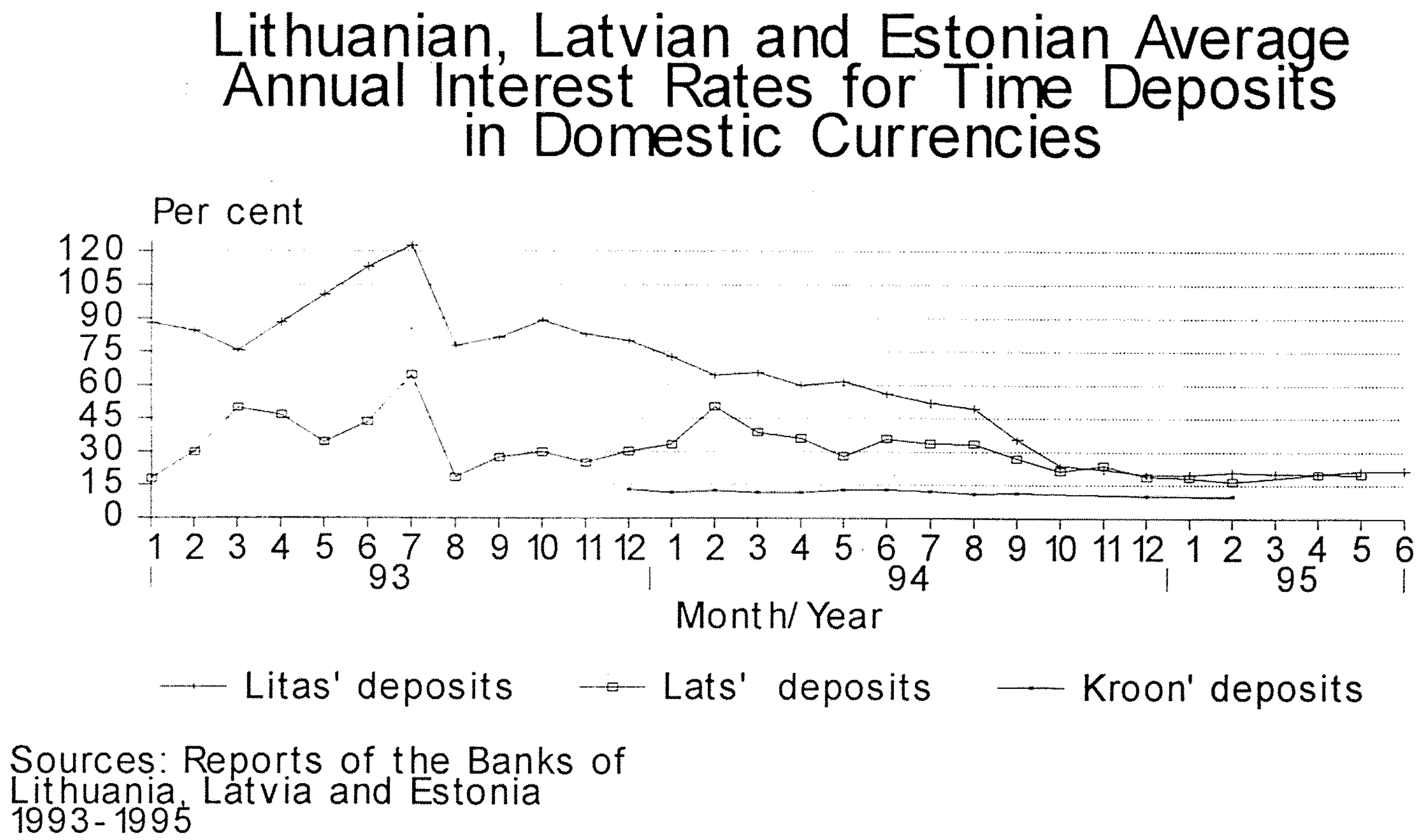


Figure 3. Lithuanian, Latvian and Estonian average annual interest rates for all time deposits (short-term 1-12 months and long-term more than 12 months, weighted average) in domestic currencies, i.e., Litas, Lats and Kroon, respectively.

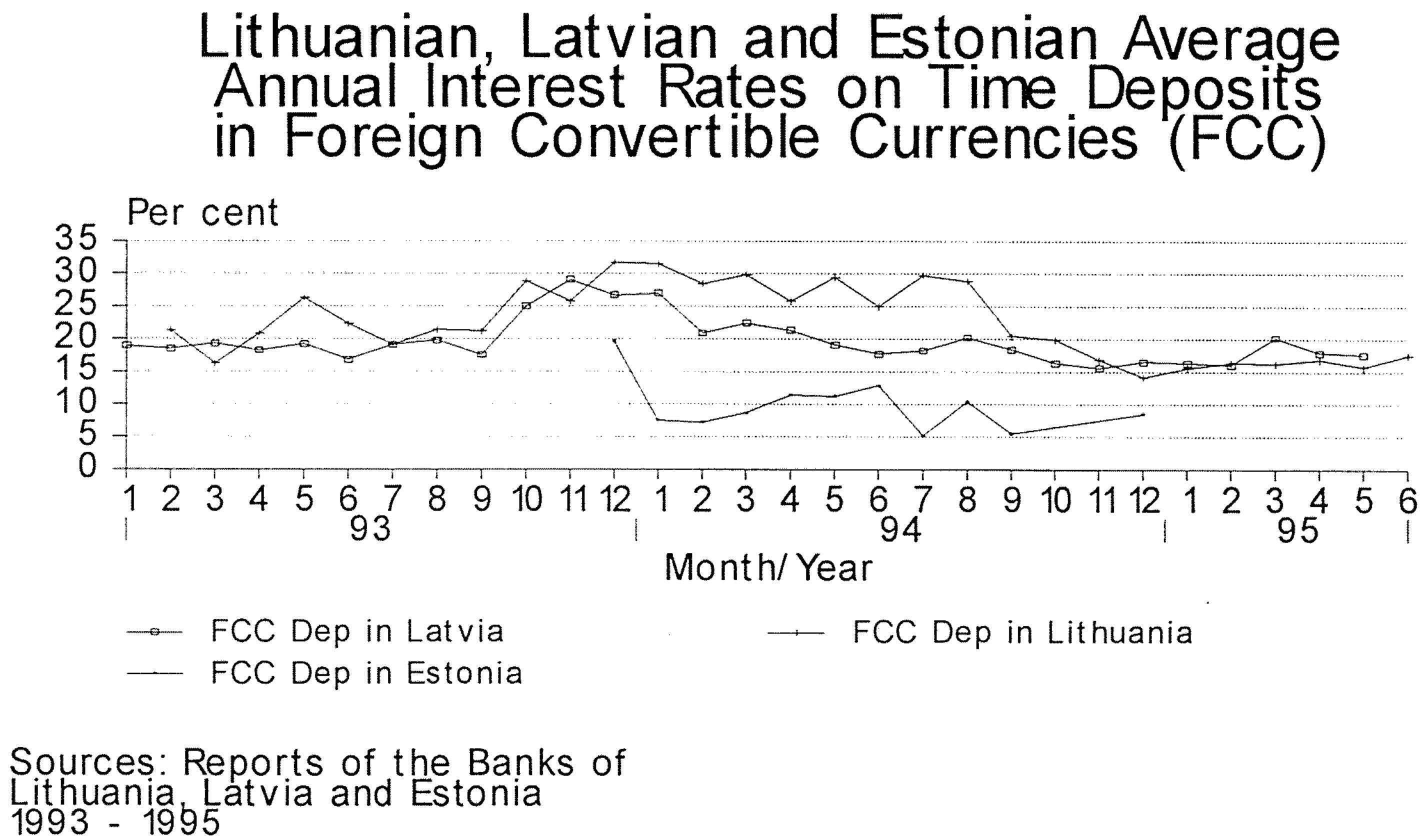
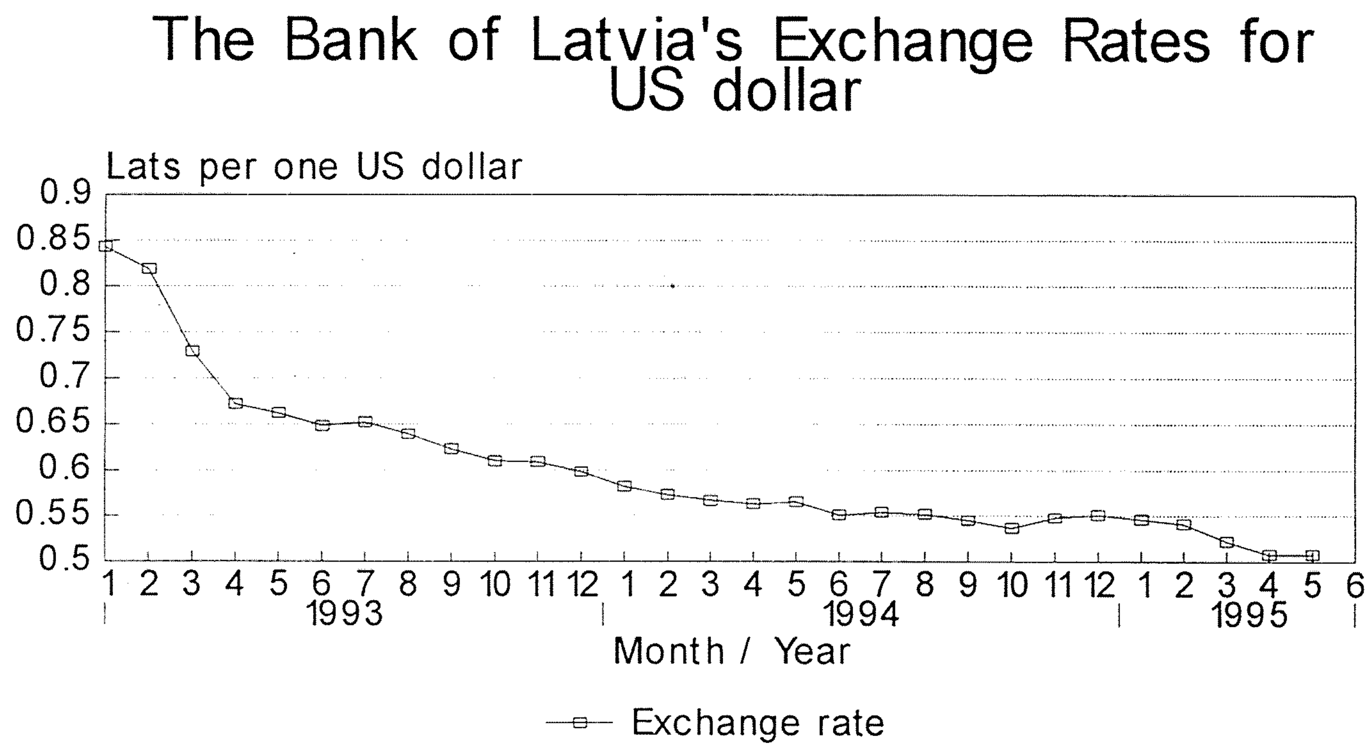


Figure 4. Lithuanian, Latvian and Estonian average annual interest rates for all time deposits (short-term 1-12 months and long-term more than 12 months, weighted average) in foreign convertible currencies (mainly in US dollars and German marks).



Source: Monetary Review of the Bank of Latvia, 1993-1995.

Figure 5. The Bank of Latvia's exchange rates for the US dollar, Lats was pegged to the SDR's in February 1994.

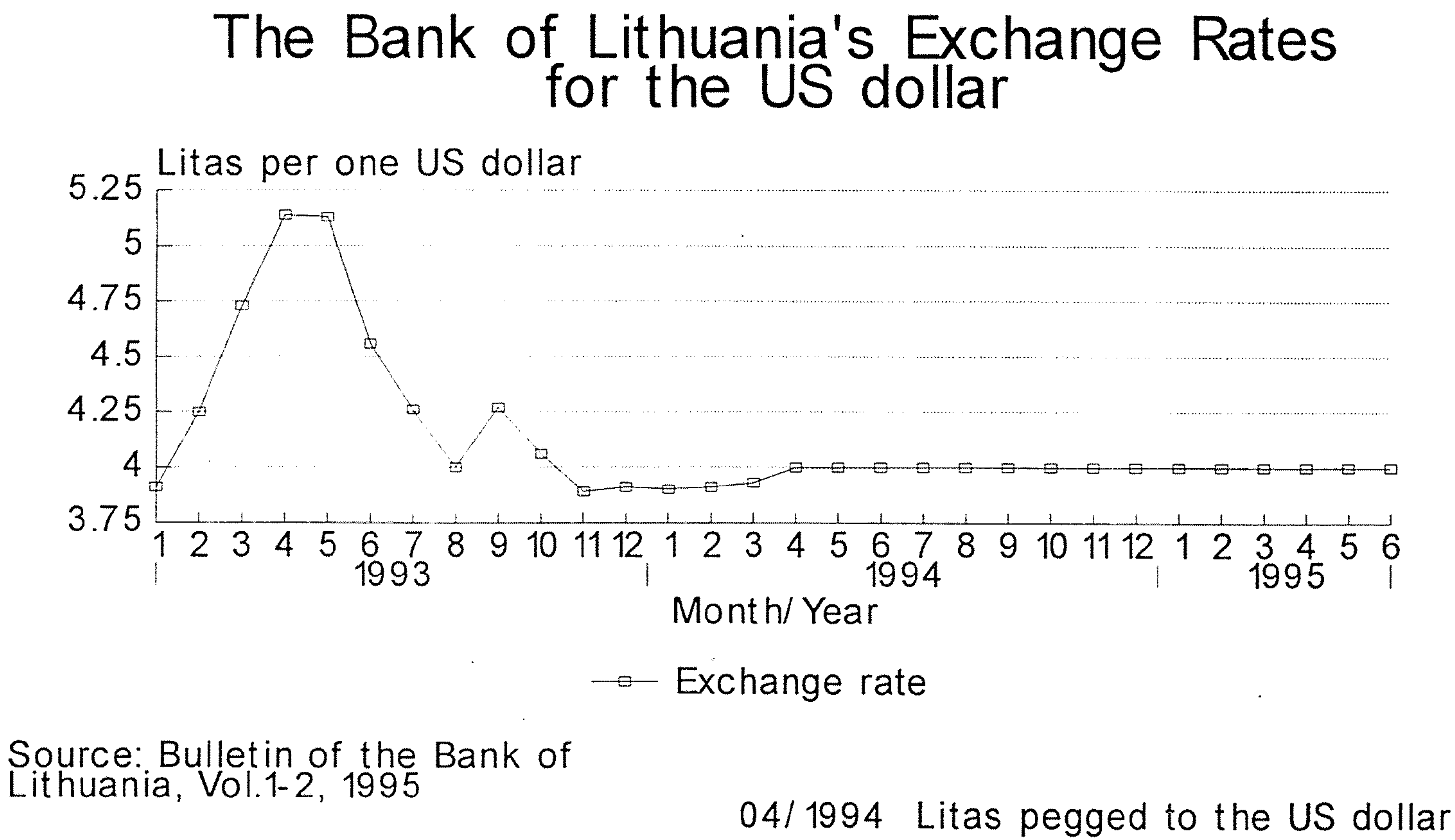


Figure 6. The Bank of Lithuania's exchange rates for the US dollar, fixed exchange rate 1 US dollar equals to 4 Litas was introduced under the currency board's arrangements in April 1994.

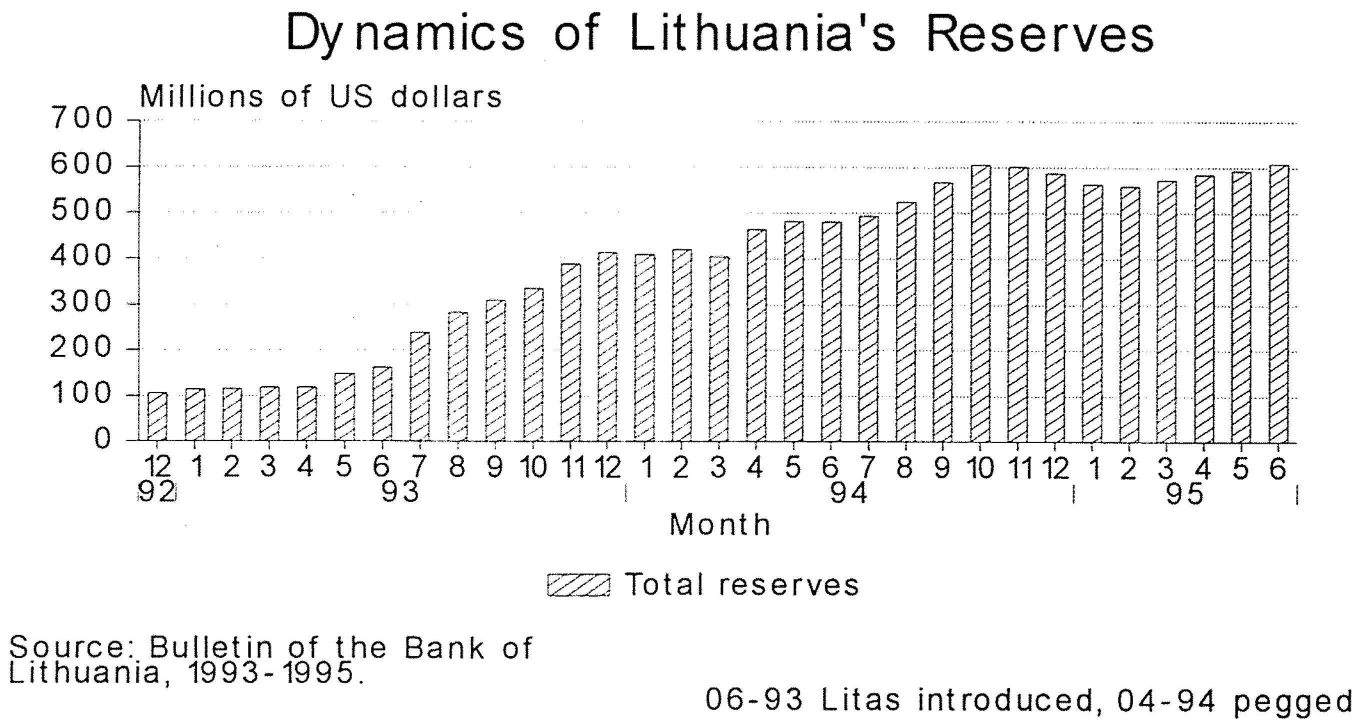


Figure 7. Dynamics Of Lithuania's Reserves (Foreign Exchange, SDR'S And Gold) In Millions of US Dollars, 1992-1995

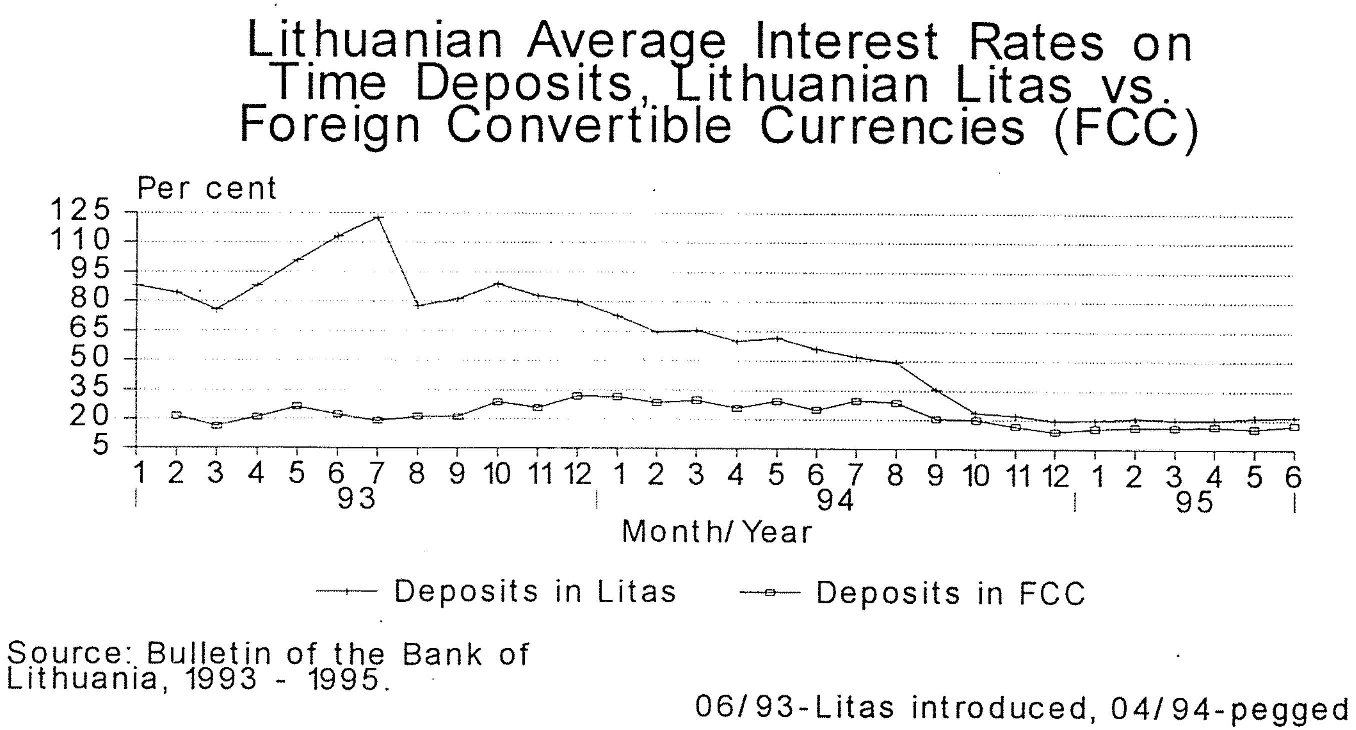


Figure 8. Average Annual Interest Rates On Lithuanian Commercial Banks Time Deposits, Litas Versus Foreign Convertible Currencies Deposits; Period From 1992 To 1995.

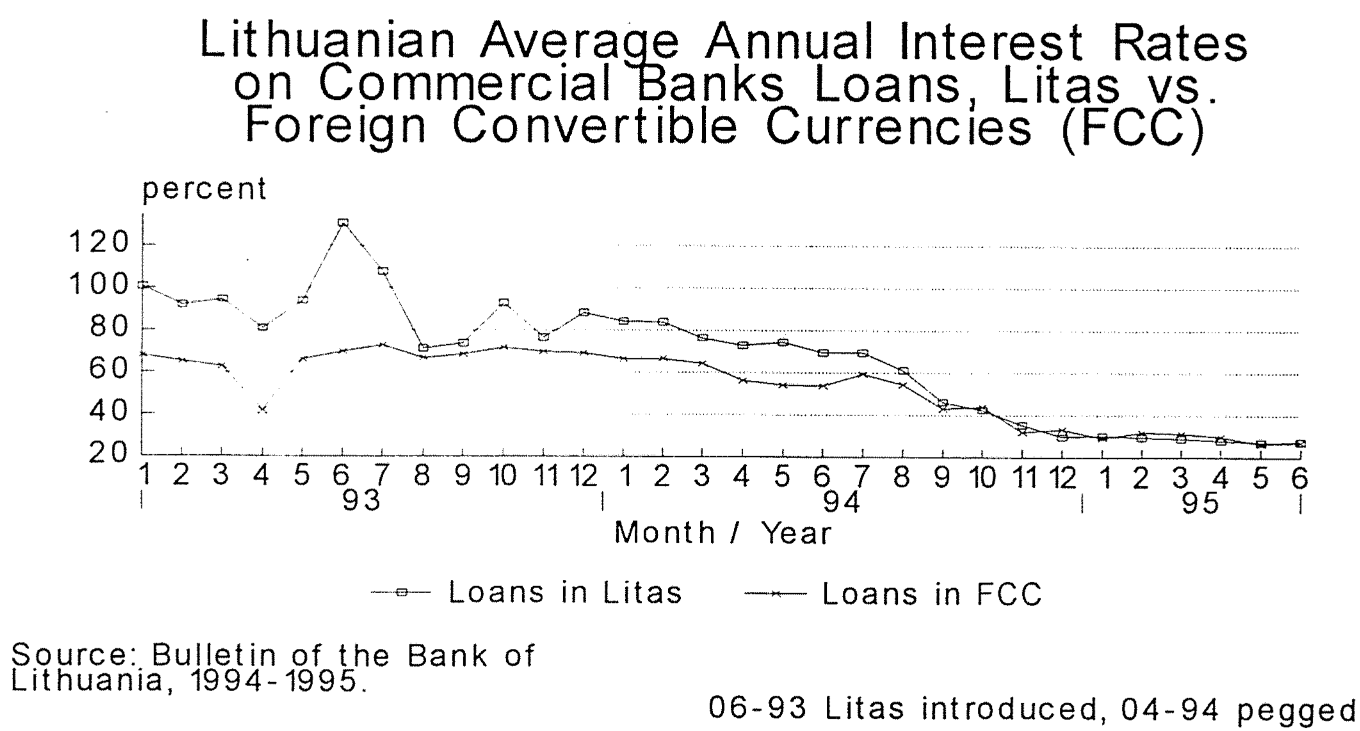


Figure 9. Average Annual Interest Rates On Lithuanian Commercial Bank Loans, Litas Versus Foreign Convertible Currencies (Fcc) Loans, Period From 1992 To 1995.

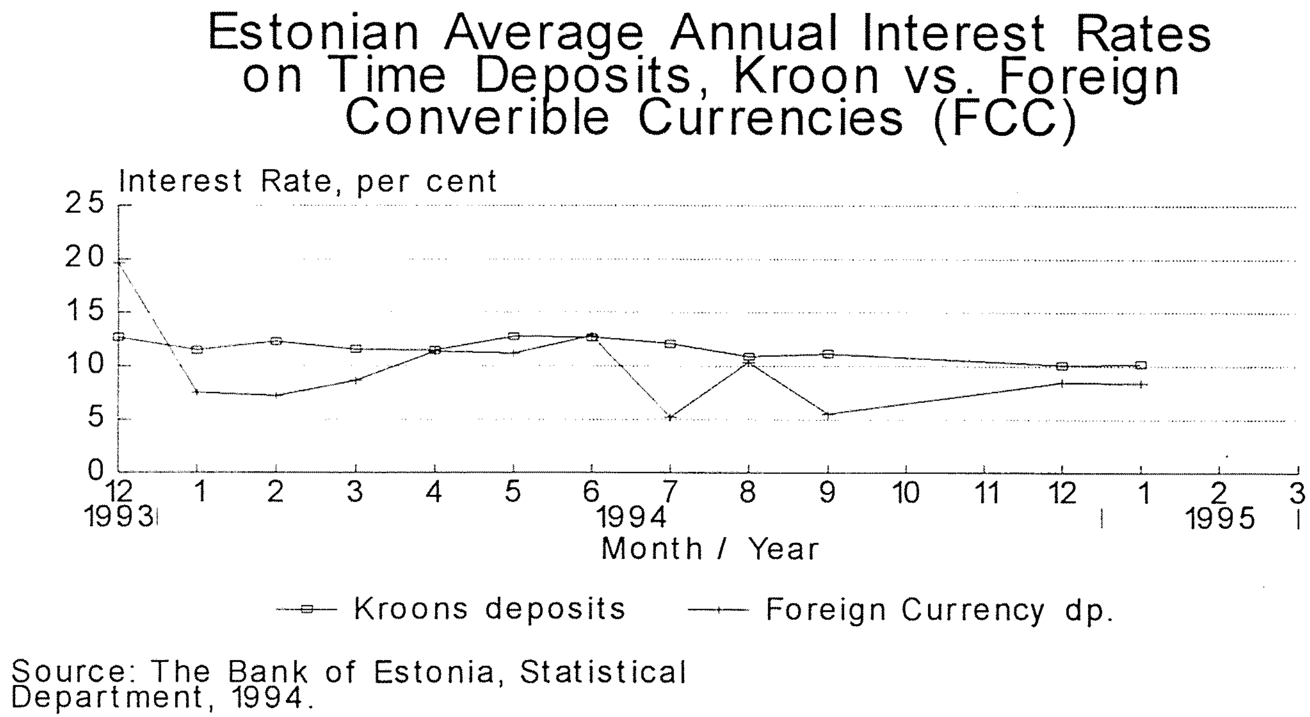


Figure 10. Average Annual Interest Rates On Estonian Commercial Bank Time Deposits, Kroon Versus Foreign Convertible Currencies (Fcc) Deposits, Period From 1993 To 1995.

TEXT BOX No 1
Adjustment Toward to a Shift in Balance of Payments Surplus under the Currency Board regime

(i) balance of payments is zero

↓

(ii)fall in domestic demand for imported goods or rise in foreign demand for currency board country goods

↓

(iii) balance of payments surplus (exports exceed imports)

↓

(iv) rise in bank reserves

↓

(v) rise in bank credit (money supply)

↓

(vi) fall in interest rates

↓

(vii) rise in income

↓

(viii) rise in demand for goods in general, including currency board notes and coins

↓

(i) rise in prices of domestic goods

↓

(x) rise in domestic demand for foreign goods or fall in foreign demand for the currency board country's goods

↓

(xi) balance of payments returns to zero - new equilibrium

Source: Hanke, S.,Jonung, L. Schuller, K., 1992.

TEXT BOX No 2.
Adjustment Toward to a Shift in Balance of Payment Deficit under the Currency Board regime

↓

(i) balance of payments is zero

↓

(ii) rise in domestic demand for imported goods or fall in foreign demand for currency board country's goods

↓

(iii) balance of payments deficit (exports are less than imports)

↓

(iv) fall in bank reserves

↓

(v) fall in bank credit (money supply)

↓

(vi) rise in interest rates

↓

(vii) fall in income

↓

(viii) fall in demand for goods in general, including currency board notes and coins

↓

(i) fall in prices for domestic goods

↓

(x) fall in domestic demand for foreign goods or rise in foreign demand for the currency board country's goods

↓

(xi) balance of payments returns to zero - new equilibrium

Source: Hanke, S.,Jonung, L. Schuller, K., 1992.

APPENDIX

LAW OF THE REPUBLIC OF ESTONIA
ON THE SECURITY FOR ESTONIAN KROON

Clause l. Security for Estonian kroon

Estonian kroon (cash in circulation, currency in current accounts and in accounts of a fixed date) is issued fully secured by the gold and convertible foreign exchange reserve of Eesti Pank.

Clause 2. Rate of Estonian kroon

The official rate of Estonian kroon will be determined by Eesti Pank with respect to German mark. Eesti Pank has no right to devalue Estonian kroon. The limit of technical fluctuation of Estonian kroon is 3 percent.

Clause 3. Exchangeability of Estonian kroon

Eesti Pank guarantees on the territory of the Republic of Estonia the free exchange of Estonian kroon to convertible foreign currencies for current needs of customers, according to the official rate of Eesti Pank.

Clause 4. Changing the amount of currency in circulation

Eesti Pank has the right to change the amount of Estonian kroons in circulation only according to a change of its gold and foreign exchange reserve.

Clause 5. Informing on the security of Estonian kroon

Eesti Pank, at least once a month, makes public information about the amount of its gold and convertible foreign exchange reserve as well as the amount of Estonian kroon in circulation.

Clause 6. Becoming effective of the law

The present law will become effective on the day Estonian kroon is issued.

A. Ruutell
Chairman
Supreme Council Republic of Estonia
In Tallinn, on May 20, 1992

ARTICLES FROM 'THE LAW ON THE BANK OF LITHUANIA'

CHAPTER I
GENERAL PROVISIONS

Article 1. The Bank of Lithuania

The Bank of Lithuania is the central bank of the Republic of Lithuania, belonging by right of ownership to the State of Lithuania.

The Bank of Lithuania shall be established and liquidated by the Seimas of the Republic of Lithuania.

Article 2. Legal Status of the Bank of Lithuania

The Bank of Lithuania is a legal person.

The Bank of Lithuania shall have a seal bearing the state emblem of Lithuania and words "Lietuvos Bankas" ("Bank of Lithuania").

The headquarters of the Bank of Lithuania shall be based in Vilnius.

The State of Lithuania shall not be liable for the obligations of the Bank of Lithuania, and the Bank of Lithuania shall not be liable for the obligations of the State of Lithuania, except in cases where the Bank of Lithuania assumes such liability of the Bank of Lithuania is established by the laws of the Republic of Lithuania.

The Bank of Lithuania shall be held accountable to the Seimas of the Republic of Lithuania.

Article 3. Independence of the Bank of Lithuania

In implementing the objectives established to it by this Law and carrying out its functions, the Bank of Lithuania shall be governed by the Constitution and laws of the Republic of Lithuania and shall be independent from the Government of the Republic of Lithuania and other institutions of executive authority.

Article 4. The Institutions of the Bank of Lithuania

The Bank of Lithuania shall have the right to establish branches, affiliates and other institutions and enterprises to carry out its functions.

Article 5. Foreign Relations of the Bank of Lithuania

The Bank of Lithuania shall represent the State of Lithuania in the central banks of foreign countries, in international banks, and in other international financial institutions, as well as at international conferences (councils) on the issues of monetary, foreign exchange, and credit policy.

The Bank of Lithuania may be a shareholder in international and foreign institutions provided that this is related to the improvement of the policy of national currency, international credit and settlements, and the implementation of the objectives of the Bank of Lithuania.

Article 6. The Exclusive Right of the Bank of Lithuania to Issue Currency

Only the Bank of Lithuania shall have the exclusive right to issue currency. Implementing the right, the Bank of Lithuania shall:

1) establish the denominations, the form, and the distinctive security and solvency features of said currency, organise the production of banknotes, buy litas and centas coins from the Ministry of Finance at nominal value, organise the transportation and storage of money, establish the procedure for removing worn and damaged currency, make up currency reserve funds, and establish the procedure for examining banknotes;

2) in accordance with the procedure established by law put into circulation and withdraw from circulation currency of the Republic of Lithuania. The Bank of Lithuania may also withdraw from circulation banknotes and coins replacing said currency. The Bank of Lithuania shall establish the procedure for the withdrawal of currency and shall announce said procedure to the public.

Article 7. The Principal Objective of the Bank of Lithuania

The principal objective of the Bank of Lithuania shall be to achieve stability of currency of the Republic of Lithuania.

Implementing the principal objective, the Bank of Lithuania must:

1) ensure the reliable functioning of the currency market and the system of credit and settlements; and

2) support the economic policy carried out by the Government of the Republic of Lithuania, provided that said policy is in compliance with the principal objective of the Bank.

Article 8. The Functions of the Bank of Lithuania

Implementing its objectives, the Bank of Lithuania shall perform the following basic functions:

1) shall put into circulation and withdraw from circulation the currency of the Republic of Lithuania;

2) may service the accounts of the bodies of power and government of the Republic of Lithuania; and

3) shall organise the sales and purchase of domestic bonds of the Government of Republic and the payment of interest thereon, and act as the registrar of Government bonds;

4) shall implement, in accordance with the procedure established by law, the monetary policy by managing the circulation of currency and credit using open market operations and other means;

5) shall advise the government on the issues of money market, credit and settlements;

6) shall accumulate and announce monetary and financial statistics;

7) shall control compliance with the foreign exchange regime;

8) shall protect and manage the state reserves of foreign exchange, gold and other precious metals;

9) shall establish the procedure for domestic and international payments, including clearings, between banks and other economic entities;

10) shall issue and revoke licenses of the banks of the Republic of Lithuania and foreign banks, as well as other credit institutions in the Republic of Lithuania and supervise their activities;

11) shall act, in accordance with the procedure established by law, as the last source of liquidation and credit in the bank system;

12) shall organise a banking information system;

13) shall establish the accounting, reporting and accountability of banks and other credit institutions licensed in the Republic of Lithuania; and

14) shall draw up the balance of payments of the Republic of Lithuania.

Article 9. Legal Acts of the Bank of Lithuania

The Bank of Lithuania shall issue legal acts within the limits of its jurisdiction.

CHAPTER II
ORGANISATION AND MANAGEMENT OF THE ACTIVITIES OF THE BANK OF LITHUANIA

Article 10. The Board of the Bank of Lithuania

The Bank of Lithuania shall be governed by the Board of the Bank, which shall comprised of chairperson, deputy chairpersons (3), and members (10).

The Chairperson, deputy chairperson, and members of the Board of the Bank of Lithuania must be citizens of the Republic of Lithuania only.

The President of the Republic, or members of the Seimas, the Government and members of boards or councils of other credit institutions, may not be the Chairperson, deputy chairpersons and members of the Board of the Bank of Lithuania.

The Chairperson of the Bank of Lithuania shall be appointed for a term of 5 years and his or her salary shall be fixed by the Seimas of the Republic of Lithuania upon the recommendation of the President of the Republic.

The deputy chairpersons and the members of the Board of the Bank of Lithuania shall be appointed for a term of 9 years by the President of the Republic of Lithuania on the recommendation of the Chairperson of the Board of the Bank the of Lithuania.

The Board of the Bank of Lithuania, except the Chairperson and deputy chairperson, shall be renewed by one third every three years.

Article 11. The Main Functions of the Board of the Bank of Lithuania

The Board of the Bank of Lithuania shall:

1) establish and approve the forms, methods and procedures of the monetary policy of the Republic of Lithuania, including the tasks of operations performed by the Bank of Lithuania in the open market, discount rates and credit interest rates, the size of reserve requirements, the procedure for holding credit and deposit auctions, and for granting specific loans;

2) determine and approve prudential requirements for banks;

3) adopt legal acts;

4) resolve issues concerning the participation of the Bank of Lithuania in foreign and international organisations;

5) resolve questions of currency emission and other issues related thereto and denoted in Article 6 of this Law;

6) establish and liquidate branches, affiliates and other institutions and enterprises of the Bank of Lithuania to carry out its functions;

7) approve the staff, structure, and work regulations of the Board;

8) apply sanctions provided for by laws banks and other credit institutions;

9) approve the Bank's annual budget, financial reports, and other reports provided for in this Law;

10) resolve issues concerning the utilisation of the property and funds of the Bank of Lithuania;

11) approve the terms and conditions of domestic and foreign loans received by the Bank of Lithuania from international financial institutions;

12) issue and revoke licenses for banks and other credit institutions;

13) settle the issues provided for in item 11 of Article 8 of this Law; and

14) determine the salaries of deputy chairmen and members of the Board of the Bank of Lithuania.

The Board of the Bank of Lithuania may authorise the chairperson of the Board to carry out a portion of its functions, except the functions established by items 1,2,4,5,8,9,10,11,12,13, and 14 of Par. 1 hereof.

Article 12. Dismissal of Members of the Board of the Bank of Lithuania

A Board member of the Bank of Lithuania shall be dismissed prior to the expiration of his or her term if he or she loses citizenship of the Republic of Lithuania or becomes President of the Republic or member of the Seimas or the Government.

A member of the Board of the Bank of Lithuania may only be dismissed prior to the expiration of his or her term if:

1) it becomes clear he or she is not able to perform his or her duties properly due to the health problems;

2) a court decision concerning the conviction of the member of the Board for a deliberate crime becomes valid;

3) he or she becomes a member of councils or boards of banks or other credit institutions, with the exception of participation in the management of international credit agencies or institutions the member whereof is the Republic of Lithuania.

Article 13. Resignation of the Members of the Board of the Bank of Lithuania

The Chairperson of the Board of the Bank of Lithuania may resign from his or her post upon submitting a resignation request to the President of the Republic of Lithuania; deputy chairpersons and members of the Board must submit resignation requests to the Chairperson of the Board of the Bank of Lithuania.

Resignation requests submitted by the Chairperson shall be considered by the Seimas; requests of deputy chairpersons and members of the Board shall be considered by the President of the Republic.

Decisions concerning resignation shall be adopted within a month of receipt of the corresponding request.

If a decision is not adopted, the person shall be considered to have resigned after one month from the day of filling of the request.

Article 14. Meetings of the Board of the Bank of Lithuania

Meetings of the Board of the Bank of Lithuania shall be held as necessary, but at least twice a month. The procedure for arranging meetings of the Board shall be established by the rules of the Board of the Bank of Lithuania.

Board members shall be informed of meetings, in writing, at least two business days in advance of said meeting.

Meetings of the Board of the Bank of Lithuania shall be considered valid if at least 9 members of the Board are present. Decisions of the Board shall be adopted by simple majority vote.

Board meetings shall be chaired by the Chairperson of the Board or by one of the deputy chairpersons in accordance with the procedure established by the rules of the Board of the Bank of Lithuania.

In the event of a tie vote, the chairperson of the meeting of the Board shall have the deciding vote.

Decisions of the Board shall be implemented by resolutions thereof, or by the instruction of the Chairperson of the Board.

Article 15. Information of the Board Member

When an issue to be resolved during a meeting of the Board is related to the commercial interest of the Board member or a member of his or her family, the Board member concerned shall give notice thereof prior to the discussion and shall not have the right to participate therein. Board members shall be considered to have commercial interests if they are shareholders, members of the board or council of a credit institution or any type of enterprise, as well as owners, co-owners, or part owners of the enterprise.

Article 16. Work Restriction for Members of the Board of the Bank of Lithuania

The Chairperson, deputy chairpersons, and members of the Board of the Bank of Lithuania, as well as persons who formerly held such posts, may not be members of boards or councils of credit institutions until one year has passed since their resignation from the respective positions at the Bank of Lithuania.

The Chairperson, deputy chairpersons, and members of the Board of the Bank of Lithuania may only work in the Bank of Lithuania; scientific, pedagogical and cultural activities may be engaged in upon consent of the Board.

Article 17. The Chairperson of the Board of the Bank of Lithuania

The Chairperson of the Board of the Bank shall:

1) direct the work of the Bank of Lithuania;

2) represent the Bank of Lithuania in the Republic and abroad without special authorisation and carry out all actions related thereto;

3) conclude employment contracts with staff members and heads of the branches, affiliates and offices of the Bank of Lithuania; encourage distinguished employees, and impose disciplinary punishment;

4) approve the allocations of duties between the Chairperson and deputy chairpersons of the Board;

5) issue authorisations;

6) approve regulations of the structural divisions of the Bank of Lithuania; and

7) execute other functions authorised by the Board of the Bank of Lithuania.

In the event of the absence of the Chairperson of the Board of the Bank of Lithuania, his or her duties shall be vested in one of the deputy chairpersons on the instructions of the Chairperson of the Board.

The Chairperson of the Board of the Bank of Lithuania must participate of the Government of the Republic of Lithuania with the right of advisory vote.

Article 18. The Staff of the Bank of Lithuania

The staff of the Bank of Lithuania shall perform the functions of the Bank of Lithuania provided for in this law, observing the regulations of their appropriate structural division and their employment contract.

The staff of the Bank of Lithuania may work only in the Bank of Lithuania, with the exception of case when the Board of the Bank of Lithuania gives its consent for outside employment. The latter provision shall not be applicable in the case provided for Par.2 of Article 16 of this Law.

Staff members of the Bank of Lithuania may not take out loans in any credit office or institution other than the Bank of Lithuania.

The employees of the Bank of Lithuania may be rendered financial services according to the procedures and conditions by the Board of the Bank of Lithuania.

Article 19. Protection of Secrets of the Bank of Lithuania

The Chairperson, deputy chairpersons, and members of the Board of the Bank of Lithuania and its staff must maintain the secrecy of information which is related to the activities of the Bank of Lithuania.

The Board of the Bank of Lithuania shall compile a list of information considered to be a secret of the Bank of Lithuania.

Information which is considered a secret of the Bank of Lithuania may only be disclosed to the institutions determined by law and in accordance with the procedure established by law.

For the disclosure of information which is considered a secret of the Bank of Lithuania and for concealment of unlawful financial operations and transactions the Chairperson, deputy chairpersons, and members of the Board of the Bank of Lithuania and its staff shall be liable in accordance with the established legal procedure.

CHAPTER III
CAPITAL, INCOME AND EXPENSES OF THE BANK OF LITHUANIA

Article 20. Capital of the Bank of Lithuania

The authorised capital of the Bank of Lithuania shall be 50 million litas.

The authorised capital shall be formed from the state funds of the Republic of Lithuania and allocations of the profit of the Bank of Lithuania.

The reserve capital of the Bank of Lithuania shall be formed from quarterly allocations from the profit of the Bank of Lithuania. Allocations shall be continued until the reserves capital reaches 200 million litas. Reserve capital may only be used to cover bank loses. When a part of the reserve capital is used to cover loses, allocations from the profit to the reserve capital shall be carried out again until the reserve capital reaches the sum of 200 million litas.

Article 21. Income of the Bank of Lithuania

The income of the Bank of Lithuania shall comprise:

1) interest on foreign reserves kept abroad;

2) interest on deposits kept with other banks and loans given to banks;

3) income received for the emission of currency;

4) income received from operations in foreign exchange, precious metals, and for securities and guarantees issued in accordance with the legal procedure; and

5) income received from other operations which are in compliance with law.

Article 22. Expenses of the Bank of Lithuania

The expenses of the Bank of Lithuania shall constitute:

1) interest payable on the deposits of credit institutions and deposits of the staff of the Bank of Lithuania kept with the Bank of Lithuania;

2) expenses for carrying out operations abroad;

3) interest paid on foreign loans;
4) expenses related to the production and issue of banknotes and coin acquisition;
6) material values depreciation costs;
7) operating costs;
8) payroll costs;
9) other specific expenses required for the performance of functions of the Bank of Lithuania provided that they are in compliance with the law.

Article 23. Profit of the Bank of Lithuania

The profit for each financial year shall be calculated after deducting expenses from the bank income.

Article 24. Distribution of Profit of the Bank of Lithuania

The profit of the Bank of Lithuania shall be distributed in the following order:
1) Fifty percent - to form the reserve capital of the Bank of Lithuania;
2) Twenty percent - to form the authorised capital of the Bank of Lithuania.
The remaining profit shall be paid to the budget of the Republic of Lithuania by the 1st of May each year.

CHAPTER IV
MONETARY REGULATION AND OPERATIONS OF THE BANK OF LITHUANIA

Article 25. The Program of Monetary Policy of the Bank of Lithuania

The Bank of Lithuania shall prepare and conduct the program of monetary policy.

Article 26. Open Market Operations

In conducting monetary policy, the Bank of Lithuania shall:
1) buy and sell debt instruments (securities) issued by the Republic of Lithuania; and
2) perform rediscount operations.

The Bank of Lithuania, pursuant to the procedure set by the Bank, shall have the right to rediscount bills of exchange and other debt instruments, denominated in litas and payable in the Republic of Lithuania, bearing the signature of at least three solvent guarantors or warrantors of which at least one shall be a bank, and maturing within three months from the date they were presented for rediscounting.

In exceptional cases pursuant to the decision of the Board of the Bank of Lithuania, bills of exchange and other obligations of commercial operations may be accepted for rediscounting provided that they have maturity not exceeding six months and bear the signatures of guarantors or warrantors of which at least one is a bank.

The Bank of Lithuania shall rediscount bills of exchange without exceeding the maximum possible rediscount amount for each bank; this limit shall be calculated as a correspondent ratio from the registered bank capital.

The Bank of Lithuania shall determine, increase or diminish the rediscount limits for each bank or shall entirely cancel rediscount operations.

Article 27. Credit Operations

The Bank of Lithuania may, pursuant to item 11 of Article 8, grant according to the conditions and procedure established by the Bank, credit institutions of the Republic of Lithuania that hold reserve requirement with the Bank of Lithuania credits for term up to 3 months, secured by any of the following assets:

1) international reserve funds: gold, foreign exchange, including exchange in their accounts with foreign banks, drafts and bills in foreign exchange;

2) debt instruments in the national currency issued and payable within the territory of the Republic of Lithuania provided that they form part of state emission; and

3) other securities, debt instruments, and precious metals which the Bank of Lithuania has the right to buy ans sell according to Law.

Article 28. Interest Rates

The rates for rediscount and credit operations of the Bank of Lithuania shall be established by the Bank of Lithuania.

Under extraordinary conditions, a maximum interest rate of credit and discount operations for all credit institutions of the Republic may be established by the Bank of Lithuania.

CHAPTER V
FOREIGN EXCHANGE REGIME (ESTABLISHMENT AND REGULATION OF THE EXCHANGE RATE), INTERNATIONAL RESERVES AND OPERATIONS WITH FOREIGN CREDIT INSTITUTIONS

Article 29. Regulation of Foreign Exchange Operations

The Bank of Lithuania shall:

1) establish the procedure for carrying out foreign exchange operations;

2) grant licenses for the execution of foreign exchange operations and revoke them when necessary;

3) establish maximum open position in foreign exchange for banks and other credit institutions; and

4) keep and manage foreign exchange reserves of the Republic of Lithuania.

Article 30. Settlement Agreements

The Bank of Lithuania may, on its own behalf or on the behalf of the Republic of Lithuania, on the instruction thereof, enter into clearing and settlement agreements or any other contracts for the same purpose with foreign states or private central clearing institutions domiciled abroad.

Article 31. Gold, Convertible Foreign Exchange and other Universally Recognized International Reserve Assets

The Bank of Lithuania shall establish, keep and manage reserves of the Republic of Lithuania which may consist of the following assets:

1) gold;

2) convertible foreign exchange in the form of banknotes or coins or bank balances held abroad in foreign currencies;

3) any other internationally recognized reserve asset, including:

a) the right to make reserve purchases from the International Monetary Fund;

b) special drawing rights (SDR) of the International Monetary Fund;

c) bills payable in a convertible foreign exchange; and

d) securities, including repurchase obligations, payable in a convertible foreign exchange which are issued and guaranteed by foreign states, the central banks of foreign states, or international institutions.

Article 32. Operations with Foreign Credit Institutions

The Bank of Lithuania shall have right to:

1) take credits from foreign and international banks and credit institutions;

2) grant credits to foreign banks and international credit institutions;

3) open accounts, accept funds into their accounts or deposits from central banks of foreign states, and international banks, credit institutions and other organisations;

4) open accounts of the Bank of Lithuania in foreign banks;

5) be the guarantor and issue letters of guarantee on the basis of pecuniary obligations of international organisations and foreign and Lithuanian legal persons; and

6) carry out other international foreign exchange operations provided by law.

CHAPTER VI
LICENSING AND SUPERVISION OF BANKS AND OTHER CREDIT INSTITUTIONS

Article 33. Activities of Credit Institutions

Activities of credit institutions - activities based on public acceptance of monetary resources in any form and the lending thereof at the expense of the institutions.

Article 34. Licensing of Credit Institutions

It shall be prohibited to engage in the activities of of credit institution without a license of the Bank of Lithuania.

The terms and conditions for granting licenses shall be established by the laws of the Republic of Lithuania which regulate the establishment and activities of banks and other credit institution , other laws of the Republic of Lithuania and legal acts issued by the Bank of Lithuania.

Article 35. Formation of Prudential and Reserve Requirements of Banks and other Credit Institutions

The Bank of Lithuania shall establish prudential and reserve requirements of banks and other credit institutions on the basis of their deposits and other borrowed funds (liabilities). The amount of prudential and reserve requirements as well as the procedure for keeping the reserves shall be established by the Bank of Lithuania by Board resolutions.

Article 36. Supervision of Activities of Banks and other Credit Institutions

The Bank of Lithuania shall supervise the activities of banks and other credit institutions which posses a license of the Bank of Lithuania.

The Bank of Lithuania shall have the right to:

1) obtain information necessary for the performance of the function of supervision;

2) inspect banks and other credit institutions and their sub-units, and examine the accounts, books, and other documents thereof;

3) issue rules, instructions and other legal acts, and take other measures necessary to ensure the efficient functioning of the credit system; and

4) apply sanctions provided for by this law and other laws of the Republic of Lithuania to banks and other credit institutions which violate the laws and legal acts passed by the Bank of Lithuania, or when their chosen risky manner of activities may cause instability in the financial system or affect the interest of clients and depositors, or when by their activities they are seeking to monopolise certain spheres of the financial system of the Republic of Lithuania.

Information which the Bank of Lithuania obtains from banks and other credit institutions for the purpose of supervision may not be announced publicly or released to other institutions of state management, control, or law and order, except as in the cases specified by laws.

The Bank of Lithuania shall have the right to examine accounts, books and other documents of any economic entity which, on the basis of information in the possession of the Bank of Lithuania, is engaged in the activities of credit institutions without a license of the Bank of Lithuania.

Article 37. Sanctions of the Bank of Lithuania against Banks and other Credit Institutions

The Bank of Lithuania shall have the right to apply against banks and other credit institutions sanctions prescribed by the laws of the Republic of Lithuania.

The validity of the resolution concerning the application of sanctions may be appealed against in court in accordance with the procedure established by law.

Article 38. Cooperation with the Authorities of Supervision of Credit Institutions of other States

CHAPTER VII
ACCOUNTS, BALANCE-SHEET AND REPORTING
OF THE BANK OF LITHUANIA

Article 39. The Financial Year of the Bank of Lithuania

The financial year of the Bank of Lithuania shall begin on the first day of January and end on the thirty-first day of December.

Article 40. Accounting

The Bank of Lithuania shall carry out accounting of assets, liabilities, and operations in accordance with the accounting procedure.

The annual financial statements shall include a balance-sheet, a profit and loss accounts, and notes to the financial statements.

Article 41. Control of the Activities and Audit of the Accounts of the Bank of Lithuania

State control institutions shall monitor lawful management and use of state property.

The Seimas of the Republic of Lithuania shall appoint auditors to audit the financial statements and accounts of the Bank of Lithuania.

Article 42. The Annual Statement of the Bank of Lithuania

The Bank of Lithuania shall, within four months after the close of each financial year, submit the annual financial statement to the Seimas.

Article 43. Reporting on Implementation of Basic Objectives by the Bank of Lithuania

The Bank of Lithuania shall semi-annually present to the Seimas of the Republic of Lithuania a report on its activities.

CHAPTER VIII
FINAL PROVISIONS

Article 44. Preferential Right of the Bank of Lithuania

The Bank of Lithuania shall have the preferential right to satisfy its claims by using all of borrower's funds in the accounts with the Bank of Lithuania, as well as the securities, precious metals and other assets deposited for safekeeping with the Bank of Lithuania or pledged by the borrower to, with the exception of required reserves.

The Bank of Lithuania shall have the right to debit, without suit, funds to the accounts of the borrowers who fail to repay the loan and fail to pay the interest thereon by the time specified in the loan agreement.

Article 45. Tax Exemption of the Bank of Lithuania

The Bank of Lithuania shall be exempt from all national and local taxes, with the exception of payments provided for Par.2 Article 24 of this Law.

Article 46. Receiving Information

The Bank of Lithuania shall have the right to receive from the Government of the Republic of Lithuania financial and economic information necessary for the performance of banking functions.

Article 47. Publication of the Data of the Bank of Lithuania

The Bank of Lithuania shall issue information bulletins on its activities at least once a month.

Article 48. Validity of the Law

The Law shall be valid to extent it is in compliance with the Law on the Credibility of Litas of the Republic of Lithuania.

Article 49. Procedure for Coming into Effect of Article 10 of this Law

The procedure established in Pars. 5 and 6 of Article 10 of this law shall not apply to deputy chairpersons and members of the Board who are appointed prior to the coming into effect of this Law.

When the first appointments are made in accordance with the procedure established by this Law, one deputy chairperson and three members shall be appointed for a three years, one deputy chairperson and three members - for six years, and one deputy chairperson and four members - for nine years.

Article 50. Declaring Certain Legal Acts Invalid

Upon coming into effect of this Law, the following legal documents shall be repealed:

1) Law of the Republic of Lithuania on the Bank of Lithuania of February 13, 1990 (Government Records, 1990, No.7-172;1992, No.29(1)-855;1993, No.16-402, No.58-1115);

2) September 4, 1990 Resolution No 1-522 of the Supreme Council of the Republic of Lithuania "On the Statute and Fixed Capital of the Bank of Lithuania" (Government Records, 1990, No.27-636; 1993, No.31-711);

3) The Statute of the Bank of Lithuania (Government Records, 1990, No.27-636; 1992, No.24-709; 1993, No.16-405, No.58-1118).

I promulgate this Law adopted by the Seimas of the Republic of Lithuania.

PRESIDENT OF THE REPUBLIC

LAW OF THE REPUBLIC OF LITHUANIA NO. I-407 ON THE CREDIBILITY OF THE LITAS

March 17, 1994
Vilnius

Article 1. Guaranteeing the Credibility of the Litas
The Litas put into circulation by the Bank of Lithuania is fully covered by gold and foreign exchange reserves of the Bank of Lithuania.

Article 2. The Amount of the Litas in Circulation
The Bank of Lithuania shall guarantee that the total amount of the Litas put into circulation does not exceed the gold reserve (at market prices) and foreign exchange reserves (according to the official exchange rate of the Litas) of the Bank of Lithuania at any time.
<u>The total amount of the Litas put into circulation shall consist of:</u>
1) bank notes and coins in circulation;
2) the sum of the balances of nominal accounts of other banks and holders of litas accounts kept with the Bank of Lithuania; and
3) the sum of the securities and promissory notes of the Bank of Lithuania in litas.
<u>Foreign exchange reserves shall consist of:</u>
1) bank notes and coins of convertible currency held by the Bank of Lithuania;
2) the amount of convertible currency held by the Bank of Lithuania in the correspondent accounts in foreign banks and the International Monetary Fund; and
3) Promissory notes, certificates of deposits, bonds, other debt securities payable in convertible currency, which are held by the Bank of Lithuania. The Bank of Lithuania may change the total amount of the Litas in circulation only by changing gold and foreign exchange reserves respectively.

Article 3. The Official Exchange Rate of the Litas
The official exchange rate of the Litas shall be established against the currency chosen as the anchor currency. The official exchange rate of the Litas and the anchor currency shall be established or changed by the Government of the Republic of Lithuania upon co-ordination with the Bank of Lithuania.

Article 4. The Exchange of the Litas
The Bank of Lithuania shall guarantee to the extent of its gold holdings and foreign exchange reserves free exchange of the litas specified in Paragraph 2 of Article 2 into the anchor currency according to the official exchange rate of the Litas, as well as free exchange of the anchor currency into the Litas within the territory of the Republic of Lithuania. Other foreign currencies shall be exchanged into litas and litas shall be exchanged into other foreign currencies according to the market exchange rate. Maximum amounts of charges for exchange operations shall be established by the Bank of Lithuania for all banks. Commercial banks shall be liable under law for the violation of the procedure of exchange operations.

Article 5. Information on the Litas

The Bank of Lithuania shall publish information on the total amount of litas in circulation gold holdings and foreign exchange reserves in the "Valstybes zinios" (Government Records) at least once a month.

Article 6. Entry into Force

This Law shall become effective as of 1 April 1994.

Article 7. Validity of the Law of the Bank of Lithuania and the Statute of the Bank of Lithuania

The Law of the Bank of Lithuania and the Statute of the Bank of Lithuania shall be valid until the adoption of a new Law of the Bank of Lithuania and to the extent it complies with the provisions of this Law.

I promulgate this Law adopted by the Seimas of the Republic of Lithuania.

President of
the Republic

RESOLUTION NO. 213 OF THE REPUBLIC OF LITHUANIA ON ESTABLISHMENT OF THE OFFICIAL EXCHANGE RATE OF THE LITAS AND THE ANCHOR CURRENCY

March 30, 1994
Vilnius

Subject to the Article 3 of the Law on the Credibility of the Litas the Government of the Republic of Lithuania upon co-ordination with the Bank of Lithuania hereby resolves:

1. to establish that US dollar shall be the anchor currency.
2. to establish that the official exchange rate of the Litas shall be 4 Litas against 1 US dollar.

Prime Minister	ADOLFAS SLEZEVICIUS
Minister of Finance	EDUARDAS VILKELIS

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12 October, 1994

Law of the Republic of Lithuania No.I-603

On the Amendment to Article 4 of the Law of the Republic of Lithuania Currency

Second paragraph of Article 4 of the Law of Republic of Lithuania on Currency was amended to read as follows: "The Bank of Lithuania shall establish the anchor currency and the official litas exchange rate following the procedure set by the Law on the credibility of the Litas".

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