

**DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT**

**STRATEGY FOR
LITHUANIA**

As approved by the Board of Directors at its meeting on 22 September 2009

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EXECUTIVE SUMMARY

The Republic of Lithuania continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank. Since 1991 Lithuania has made substantial progress in transition and structural reforms. Some 75 per cent of economic activity is in the private sector and price and trade liberalisation, enterprise restructuring and effective financial sector reforms have taken place. There is an open foreign trade regime and no major constraints to foreign investment.

Economic activity in Lithuania has slowed drastically over the past year. Driven by strong domestic demand and substantial capital inflows, real GDP rose by an annual average of 7.5 per cent per year since 2000, before moderating to 3 per cent in 2008. As other Baltic countries, Lithuania has been increasingly affected by the deceleration in credit growth and falling asset prices. In addition, the global financial crisis, the difficulties in the whole Baltic region, and falling external demand as of mid-2008 led to a further slowdown, with the Lithuanian economy falling into recession in the second half of 2008. Both domestic and external imbalances have been high in recent years, leaving Lithuania vulnerable to the global financial turmoil. In particular external financing conditions and global growth prospects have deteriorated significantly over the past year. Current indications suggest a substantial reduction in the availability of finance in the coming years for households, corporates, municipalities and larger infrastructure projects. In 2009, the economy is likely to contract by some 18 per cent. As a consequence, unemployment and regional disparities are expected to rise further. So far, the banking system has mainly been affected by rising money market interest rates and decelerating credit growth while the share of non-performing loans is rising substantially, forcing banks to increase credit loss provisions. However, the main foreign (Scandinavian) parent banks remain committed to staying in the region.

The government has taken sizeable and timely steps to ensure financial stability and prudent fiscal policies. However, with a challenging external environment in the coming years, further bold policy action will be required in order to safeguard competitiveness and progress with reform made to date. Over the previous strategy period, the government made only limited progress with the remaining elements on the reform agenda. While the business environment is among the best in the region, challenges remain with regard to combating corruption, reforming the judicial system, and modernising education and health care. Privatisation moved a step closer to completion with the sale of the government's stake in the AB Mazeikiu Nafta oil refinery at the end of 2006. At the same time, the government has strengthened its involvement in the energy sector through the establishment of a majority owned holding company (LEO LT), mainly due to the large investment needs in this sector over the coming years. The closing of Ignalina nuclear power station by the end of 2009 constitutes a particular challenge, which could lead to significantly higher energy costs in 2010 and beyond. While the impact of the crisis is severe, the government remains committed to achieving the Maastricht criteria as soon as possible, with the main challenge being the budget deficit in the coming years.

In the current environment the main objectives of the government are to secure financial

and macroeconomic stability while keeping structural reform on the agenda. Investor confidence will be crucially influenced by the speed of adjustment of external and domestic imbalances as well as the ability to improve price competitiveness and to control the deterioration in public finances. In the medium-term, re-focusing the economy towards the tradable sectors and developing key sectors for future growth will be equally important. Against this background, the key transition challenges for Lithuania include:

- **Further strengthening the stability of the financial system**, supporting the smooth functioning of markets and further development of financial intermediation, mainly for SMEs through equity and mezzanine capital, and improving financial supervision, corporate governance and business practices.
- **Strengthening measures to counteract the effects of the crisis on the real sector** by further improvements in the business environment to retain investor confidence, including more extensive and consistent enforcement of laws and improved transparency in public procurement.
- **Ensuring security of energy supply** after the anticipated closure of Ignalina Nuclear Power Plant in 2009 remains a key challenge. This requires major decisions as regards to alternative sources of energy, including the development of new power links to the EU energy markets, reduce energy intensity and meet environmental targets and develop renewable energy.
- **Improving long-term competitiveness**. Further ‘market-sustaining’ reforms in the areas of governance and enterprise restructuring, education, competition policy and infrastructure reform will be necessary to ensure competitive advantages attracting foreign investment.
- **Modernising municipal and environmental infrastructure** with the assistance of EU structural and cohesion funds, private sector involvement and commercial co-financing from local sources. There is limited private sector participation in municipal sectors including water and sewage, urban transport and in the development of state transport infrastructure.

Since the last country strategy was approved, the Bank’s activities in Lithuania have remained very limited as a result of significant progress in transition and reflecting the further development of a very competitive banking sector dominated by Nordic banks. The Bank has signed 11 projects for an amount of EUR 49 million in 2006 – 2008.

Until a new medium term strategy is adopted by the Board of Governors, the Bank’s operational objectives in Lithuania will remain in accordance with the strategic outline for the years 2006 – 2010 agreed upon in Capital Resources Review 3, while also addressing the crisis needs in Lithuania and across the region, without questioning graduation. The Bank will work closely with the commercial banks and other IFIs to support the financial system and mobilise financing for nationally important projects in infrastructure and energy sectors as well as facilitate lending to SMEs and financing of energy efficiency projects. The Bank will also look for other opportunities to address the enhanced needs in Lithuania due to the ongoing financial crisis.

In light of the crisis and the external environment outlined above, the Bank's activities in Lithuania will be based on the following operational objectives:

- Foster commercial banks' continued lending to the corporate sector, particularly to SMEs, by providing long term debt and equity to financial institutions and invest in mezzanine and equity funds to ensure availability of financing.
- Promote investments in renewable energy and to improve energy efficiency as well as energy security also through supporting the development of power links.
- Provide higher-risk products such as equity for local corporations to fund their growth and improvements in competitiveness as well as to strengthen their corporate governance. Particular attention will be paid to local companies' investments in the context of cross-border expansion.
- Where appropriate support municipalities through public-private partnerships and through financial institutions to ensure commercial co-financing for EU funded projects.
- Proactive review and management of the Bank's portfolio to maintain its high quality.

The Bank will continue to ensure that all EBRD operations in Lithuania meet sound banking principles, have transition impact, are additional and are subject to the Bank's Environmental and Social Policy and incorporate, where appropriate, Environmental and Social Action Plans.

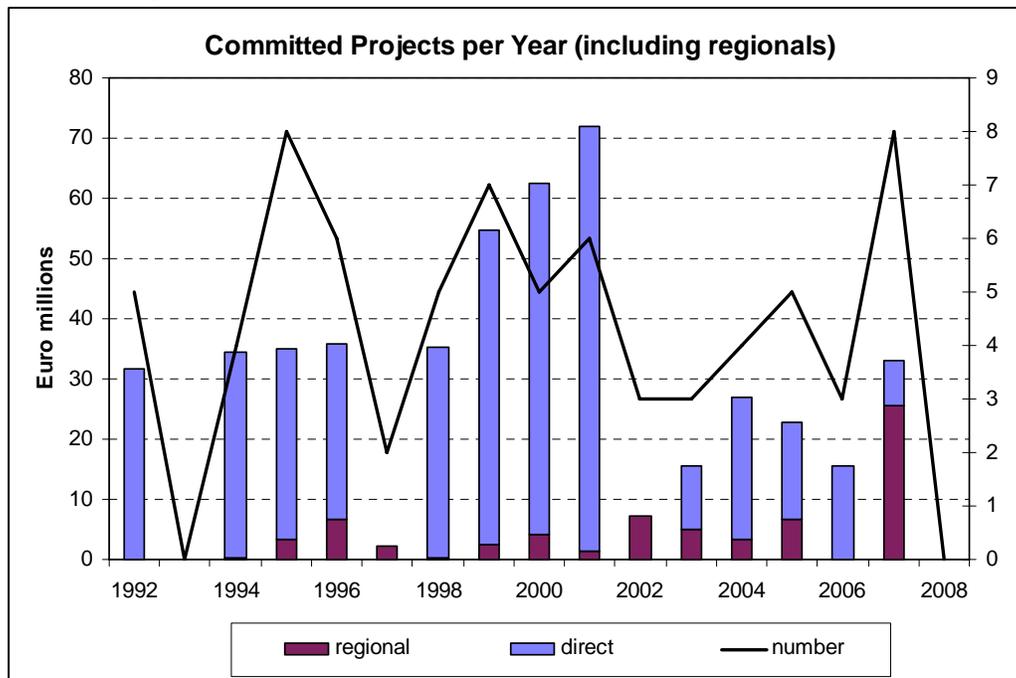
1. THE BANK'S PORTFOLIO

1.1 Overview of activities to date

The Bank has been supporting Lithuania's successful transition to a market economy by financing mostly projects in various economic sectors, but with an emphasis on the financial and infrastructure sectors. Up to March 2009, the EBRD has committed a total of EUR 485 million. Thirty-five per cent of the cumulative business volume relates to FI reflecting the Bank's important role in the sector. The Bank's role in MEI and corporate sectors has also been important with 31 per cent and 25 per cent of total commitments respectively. In the energy sector EBRD's role has remained marginal with only 9 per cent of total commitments.

Chart 1 below illustrates the activity of the EBRD in terms of the number of projects and amounts committed by EBRD in Lithuania since 1992. The Bank's activity started early concentrating in direct projects with the biggest volumes between 1998 and 2001. In 2008 no new projects were signed in Lithuania. This reflects Lithuania's progress in transition and the strong presence of commercial banks in Lithuania before the crisis.

Chart 1 (as of 31 April 2009)



The current portfolio is EUR 158 million or 0.7 per cent of total Bank portfolio. It has decreased from the end of 2005 by 21 per cent from EUR 200 million. A substantial portion, 30 per cent, of the current portfolio relates to MEI. Banks and Equity Funds represent 34 per cent of the portfolio, a reflection of EBRD's strong support to SMEs. Exposure to transport sector is through a loan to the Lithuanian State Railways representing 18 per cent of the current portfolio. The portfolio is below 60 per cent private, reflecting the high share of municipal exposure in the portfolio. Equity

investments' share in the portfolio is 72 per cent, impaired assets represent 12 per cent of the portfolio and the portfolio risk rating is at 5.49, similar to the risk rating of Central Europe and Baltics portfolio of 5.63.

1.2 Implementation of the previous country strategy

The Bank's country strategy for Lithuania, approved in March 2006, set four main strategic priorities:

- Support large, complex or sensitive transactions that would benefit from the Bank's expertise in project structuring, corporate governance and mobilising co-financing;
- Support the expansion of local companies, particularly in cross-border projects, for example into or from Russia or other CIS countries;
- Promote SME and municipal financing and energy efficiency through financial intermediaries, enhanced where appropriate with EU or other donor support;
- Encourage the development of local capital markets, for example in investing in the local securitisation of mortgage loans.

Overall, the Bank partially achieved the operational objectives set out in the previous Country Strategy. The Bank continued its support to SMEs through the financing of Siauliu Bankas, a syndicated loan and participation in an equity increase, as well as through investments in regional funds one of which is focusing in the Baltics. The Bank has built on a good relationship with City of Kaunas by signing a syndicated loan to Kaunas Trolleybus company. In 2007, the Bank signed a regional operation with a Lithuanian energy saving company, to support its expansion in Latvia and Ukraine. During the last strategy period the Bank maintained an active policy dialogue with various Lithuanian authorities promoting the use of PPP where appropriate. The Bank has been working on building a pipeline of projects, focusing on energy security, including energy efficiency and renewable energy, on private sector involvement in the provision of public services and on cross-border investments.

1.3 Transition Impact of the Bank's Portfolio and Lessons Learned

1.3.1 The Financial Sector

Banking – At the end of the 90s, the Bank supported the privatisation of the Lithuanian Agricultural Bank (Lietuvos Zemes Ukio Bankas - LZUB), later called 'Nord LB Lietuva'. The provision of a Board Member at the Lithuanian Development Bank (LDB) was successful in ensuring the viability of the institution and achieved transfer of know-how and demonstration of good practice in corporate governance. A *lesson learned* from the project with the LZUB/ Nord LB is that EBRD proved to have little influence and involvement in the privatisation process. Sufficient power to intervene in the case of undue delays in privatisation should be ensured in similar cases, i.e. through incorporating significant penalty clauses (PER00-062).

NBFI – The Bank's operation with the insurance company Lietuvos Draudimas was approved in 2001 and supported privatisation and the entry of a key strategic investor into

the insurance market. Positive impact includes an increased scope of products and strengthened corporate governance. A *lesson learned* from Lietuvos Draudimas is that privatisations in particular benefit from the involvement of a strong strategic investor (PER05-159).

(M)SME – Lithuania’s SME sector has benefited from the TAM and BAS initiatives and the presence of Baltic equity funds. Only one Lithuanian bank participated in the EU/SME facility. Since 2006, the Bank helped Siauliu Bankas (SB) to expand its services for small businesses with loans, equity and TC. The Bank has financed leases to SMEs, though only on a small scale.

Private Equity Funds – Private equity funds targeted the Baltics later than Central Europe with a number of regional funds, such as the Baltic Small Equity Fund, Baltic Investment Funds I, II, and III, and the Askembla Growth Fund. These funds include 70 investee companies, of which 22 are in Lithuania. Some of the sub-investments provided attractive returns. In 2007, the Bank purchased equity in the BaltCap Fund, a pan Baltic private fund which in turn will invest in Lithuania.

Overall, transition impact within the *Financial Sector* is rated *Moderate*.

1.3.2 The Enterprise Sector

Agribusiness – In 2003, the Bank approved an operation with UAB VP Market for facilitating business expansion and the provision of retail services in small towns and rural areas. The Bank also provided a grain receipts credit line to Siauliu Bankas resulting in a number of local banks providing lending against warehouse receipts. A *lesson learned* from the VP Market operation, is that early implementation of objectives related to Bank policy and mandate reduce the risk to transition impact and support the achievement of overall excellent results (PER06-179).

Telecommunication – Further to its early and highly successful Telecom Development International project, EBRD supported the IPO of Lietuvos Telekomas starting in 2000. The Government’s privatisation programme was effectively supported, but with less successful results on the regulatory side and with regard to the planned introduction of international investors. A *lesson learned* from this operation is that the Bank should have actively engaged local authorities ahead of the operation, i.e. requesting to appoint the regulatory authority as a pre-requisite for the IPO (PE02-206).

General Industry – The Bank’s 2000 equity investment in Drobe Wool, one of the largest Eastern European manufacturers of pure wool and wool blend fabrics, was to support the privatisation, restructuring and the investment programme of the company. However, the failure of the restructuring plan led to an unsatisfactory Transition Impact and negative demonstration effects. A *lesson learned* from this operation is, that financial investors are likely to be less well equipped to turn around a textile company than a strategic investor especially in an environment of growing costs and increasing competition.(PE07-388).

Overall, transition impact within the *Enterprise Sector* is rated *Moderate*.

1.3.3 The Infrastructure Sector

MEI – The City of Vilnius Infrastructure Improvement operation was approved in 2003 in order to improve the City’s capacity for financing infrastructure projects, and to support the elaboration of an Urban Traffic Management and Control System. The City of Kaunas saw a number of public transport investments and TC operations, aiming at improved commercial performance of the City’s bus and trolleybus companies. A *lesson learned* from the City of Vilnius project is that TC should have the full backing of the prospective client for ensuring greater acceptance and strengthening sustainability of the resulting recommendations (PE05-304).

Transport – The only recent Bank project in this sector is the Lithuania Railways Corridor IX, supporting the restructuring of the state-owned railway company Lietuvos Gelezinkeliai and financing technical rehabilitation measures. Transition objectives achieved include the adoption of the new railway law, the implementation of a five-year business plan, labour restructuring and the closure of some non-profitable lines.

Power – Apart from an early emergency rehabilitation loan, EBRD has been closely working with the Lithuanian and the Polish authorities, as well as the EC, to support the development of the Polish-Lithuanian Interconnector project. This connection, which has been signed by all relevant parties in 2008 will link the Baltic grid to the continental network in order to increase overall capacity and improve reliability.

Energy Efficiency – In the past five years the Bank has had a single transaction in this sector, an equity increase in Dalkia Litesko. This is the Lithuanian ESCO subsidiary of the Dalkia group and operates successfully, by regional standards, with a portfolio narrowly focused on district heating investment and good financial performance. Anticipated transition impact objectives, e.g. support of a private market for energy services, and demonstration of energy efficiency investments seem to be achieved.

Overall, transition impact within the *Infrastructure Sector* is rated *Moderate*.

2. OPERATIONAL ENVIRONMENT

2.1 General Reform Environment

Since independence in 1991, Lithuania has made steady progress in transition. In many areas of reform the country took the lead among the transition economies. The transition indicator scores published in the 2008 *Transition Report* indicate that Lithuania is among the most advanced in transition in the new EU member states in each of the nine categories measured. In three categories – price liberalisation, trade and foreign exchange liberalisation and small-scale privatisation – Lithuania has already achieved the standards of a well-functioning market economy.

In the first half of this decade Lithuania's reform agenda was anchored to the adoption of the EU *acquis communautaire* and resulted in entry to the EU in May 2004. Since EU accession there has been some progress finalising privatisation of the remaining state-owned companies with the sale of the government's stake in the AB Mazeikiu Nafta oil refinery in 2006. While Lithuania's business environment remains relatively attractive – the country is among the top performing transition countries in the World Bank's 2009 Doing Business report and has a regulatory framework in many respects comparable to or better than established market economies – employment legislation, investor protection and starting a business are viewed as relatively weak areas according to Doing Business. Both petty and high-level corruption remain issues of concern, and much-needed reform to Lithuania's judicial system has also been hampered over the recent years by a series of judicial scandals and low levels of public trust in the courts. As a result of these factors, Lithuania fell from 4th to 7th place among the transition countries on Transparency International's Corruption Perceptions Index between 2006 and 2008.

While the demand for labour has been strong in recent years, emigration has added to an acute shortage of graduates and other skilled workers in the labour market. Despite increasing employment in the services sector, a disproportionately high percentage of the workforce is still engaged in the agricultural sector. Vocational education and training systems are in need of updating in order to equip the workforce with skills relevant to the private sector's needs to ensure long-term competitiveness.

2.2 Political developments

Parliamentary politics in Lithuania continues to be hindered by both ideological and personal conflicts, which have weakened the capacity of successive governments to pursue an effective and sustained reform agenda since Lithuania's accession to the EU in 2004. The October 2008 parliamentary elections did result in a reduction, from eight to seven, in the number of effective parties and electoral coalitions in parliament (the *Seimas*). However, this is unlikely to result in a significant break from the past practice of frequent intra-coalition squabbles that have complicated the policymaking process for the past several years.

The October 2008 Seimas election resulted in a moderate shift in the balance of political power, from the centre-left coalition led by the Social Democrats to a centre-right coalition led by the conservative Homeland Union-Lithuanian Christian Democrats (TS-LKD) alliance. The four-party coalition includes TS-LKD, the Liberal Movement (LS), the Liberal and Centre Union (LCS) and a new party, National Resurrection (TPP). TS-LKD dominates the government with control of six ministerial portfolios, including Finance and Economy, while the remaining three parties have two ministries each and three are run by independents.

Despite the coalition enjoying a comfortable majority in the Seimas, the severe pressures emanating from the economic crisis are taking a toll on the coalition's cohesiveness, with both the need for fiscal belt-tightening as well as reforms in the area of social policy and

education opening up intra-coalition faultlines. Public discontent with the government's austerity programme, which cuts costs, including on public sector wages, and increases revenues through higher taxes, is growing rapidly. A protest march against tax increases in mid-January 2009 resulted in violent confrontations with the police. More protests are likely, mirroring the extent of social dislocation brought about by the economic downturn in Lithuania.

Presidential elections took place against this backdrop on 17 May 2009. Lithuania's widely respected and politically independent European Commissioner, Dalia Grybauskaitė, won a resounding victory with 68.2 per cent of the vote to become Lithuania's first female president. Grybauskaitė's candidacy was backed by the Prime Minister and the ruling TS-LKD, and she has openly backed Kubilius' fiscal austerity package. While the Lithuanian president's constitutional powers do not formally extend to the economic realm, the scale of Grybauskaitė's victory and her reputation as an effective European Commissioner for the Budget mean that Grybauskaitė is likely to be active in driving the anti-crisis and economic reform agenda forward.

2.3 Macroeconomic conditions relevant for the Bank's operations

Real GDP growth decelerated significantly in 2008 in Lithuania, with a contraction in the economy recorded in the second half of 2008. For the year as a whole growth rose by 3 per cent compared with 8.9 per cent in 2007. The initial slowdown came as a response to decelerating credit growth, falling house prices and the effects of rising inflation. Since mid-2008, the slowdown was reinforced by the international financial turmoil and falling external demand. In 2008, private consumption remained relatively resilient, thereby counterbalancing the rapid slowdown in investment, while also exports recovered strongly with the reopening of the Mazeikiu Nafta oil refinery following repair works in late 2007. The negative contribution of net exports was thus much reduced in 2008. 2009 has started with a dramatic decline in output growth of -13.3 per cent compared to 2008 in the first quarter, as both household and industrial confidence slumped, firms reduced stocks and export demand dried up. While some stabilisation appears to have taken place in the second quarter, 2009 will be challenging with credit scarce and external demand weak. Moreover, with tax revenues falling rapidly, further cutbacks in fiscal expenditure will be necessary which in turn will have an adverse effect on growth.

Inflation gradually increased since 2004 as the economy became increasingly overheated. CPI inflation peaked at 12.5 per cent in June 2008 but has since decelerated to stand at 5.2 per cent in May 2009. The pick-up in inflation since the end of 2005 resulted in Lithuania missing the Maastricht inflation criterion for euro adoption in 2006 and 2008. Average inflation has remained high in 2008 at 11 per cent, with tariff increases as well as food and energy prices adding to domestic price pressures. Wages continued to grow rapidly during 2008, by an average of 19.4 per cent, which was almost the same as in 2007 and well above levels that could be motivated by labour productivity gains. Towards the end of 2008 and in early 2009, wage growth has however decelerated rapidly and public sector wage cuts of around 10 per cent have been approved by the parliament, thereby reducing inflationary pressures and halting the erosion in

competitiveness. The reduction in inflation may nevertheless be counterbalanced in 2010 by rising electricity prices linked to the closure of Ignalina nuclear power station. The government remains committed to euro adoption and achieving the Maastricht criteria as soon as possible, but while inflation may move below the reference value, the budget deficit is instead becoming the key challenge. The unemployment rate has started to rise rapidly since mid-2008 when it still stood at a historically low level of around 4.5 per cent. In the first quarter of 2009 it had already reached 11.9 per cent of the labour force and is now putting additional pressure on public finances and non-performing loans.

Despite high GDP growth, the fiscal balance has shown a deficit in recent years. In 2008, the budget deficit increased to 3.2 per cent of GDP as revenues declined in response to the slowdown in the economy. The government has implemented sizeable corrective actions to maintain fiscal and macroeconomic stability as well as investor confidence. These measures have generally been well received and seen as credible, as also suggested by a successful Eurobond issue in June 2009. In December 2008 and in May 2009, the government adjusted the 2009 budget with measures of more than 7 per cent of GDP while further fiscal consolidation measures are being drafted. Public debt in Lithuania remains low in comparison to other countries in the region, at 15.6 per cent of GDP in 2008. As growth is expected to remain weak, further measures will be needed to achieve a budget deficit of below 3 per cent of GDP, which is the reference value for adopting the euro.

Lithuania's current account deficit has widened rapidly as the growth of imports has outstripped that of exports. The current account deficit rose to 14.6 per cent of GDP in 2007 before narrowing slightly to 11 per cent in 2008. A more rapid reduction in the deficit came in the last quarter of 2008 when the current account deficit stood at 3.8 per cent of GDP as domestic demand slowed markedly. Net FDI inflows remained resilient in 2008 at US\$ 1.5 billion (3.1 per cent of GDP), covering almost 25 per cent of the current account deficit but are expected to slow significantly in 2009.

In the financial sector, credit quality is rapidly deteriorating which in turn has forced the main Nordic parent banks to increase provisioning and raise new capital. The presence of foreign banks remains a positive factor, also given that subsidiary banks can draw on financial sector stabilisation programmes in the home countries, and major parent groups have confirmed their commitment to staying in the region. Overall, the banking system remains sound, and foreign ownership has over the years led to the necessary restructuring and recapitalisation of the system, the introduction of a wider array of products and services and improved corporate governance and transparency. The authorities have also taken steps to support the banking sector, including raising the deposit insurance cover to EUR 100,000 and reducing reserve requirements for banks.

The economic outlook is challenging in Lithuania as the domestic adjustment of imbalances coincides with the global slowdown in growth and much deteriorated financing conditions. The construction and real estate sectors in particular are expected to see a substantial contraction in 2009. The economy is expected to contract by some 18 per cent in 2009 and only stage a moderate recovery thereafter. This will put severe

pressure on public finances and general living standards in the medium-term. Lithuania has not drawn on any IMF led financial package, partly due to timely measures to address the deteriorating budget situation, but lending has increased from other IFIs while available EU structural funds are also being used. While there is a need for policy measures addressing the immediate risks to macroeconomic and financial stability, efforts to safeguard long-term competitiveness and external sustainability will be equally important. These include adjusting wages and containing the budget deficit in the short-term, while shifting production towards more export-oriented sectors, as well as finding sustainable solutions in the area of energy, education and health care in the medium term. Maintaining an ambitious fiscal stance will be crucial in view of complying with the Maastrich criteria for entering the euro area within a realistic timeframe.

2.4 Transition successes and challenges

The following sector-by-sector analysis of remaining transition challenges highlights several priority areas.

Energy and Infrastructure sectors

Energy: *energy supply and security, as well as energy efficiency are urgent priorities.*

Following the unbundling of Lietuvos Energija in 2002, remaining challenges in the power sector relate to energy generation and distribution. As for the former, Lithuania closed Unit 1 of Ignalina at the end of 2004 as agreed during the EU accession process, and is committed to close Unit 2 by the end of 2009. The electricity produced at Ignalina meets approximately 70 per cent of Lithuania's demand. By then Lithuania will become a net importer of power, mainly from Russia on which it already relies for natural gas. To reduce this dependence, the 1,800-MW Lithuanian Power Plant is being upgraded and a power link of 1,000 MW with Poland should be in operation in 2015. In April 2009, the Baltic governments agreed on creating a common electricity market by 2013 at the latest and to build a power interconnection between Sweden and Lithuania. It was also agreed to push on with the construction of a new nuclear power plant in Lithuania by 2018. Until new energy sources are developed, electricity prices could rise sharply (by up to 100 per cent according to some estimates) with significant impact on both inflation and economic growth. There has been progress in adjusting electricity tariffs to reflect long run marginal cost. Market opening is taking place in line with the new electricity law and commitments made under the EU negotiations.

In early 2008 further steps were taken to establish a "national champion" in the energy sector. This involved the merger of the state's holdings in Lietuvos Energija (handling transmission, trade and regulation of electricity supplies) and Rytu Skirstomieji Tinklai (eastern electricity distribution company) with AB VST (western electricity distribution company) owned by a private equity company NDX Energija. This created the Lithuanian Electricity Organisation (LEO LT), in which the state will hold 61.7 per cent of the shares. LEO LT will be an investment vehicle for the country's energy projects, such as the new nuclear power plant and power links to Poland and Sweden. While the details are not fully clear, LEO LT will be of strategic importance and therefore ineligible for privatisation. In view of the European Commission's push for energy sector

unbundling, it will be crucial to develop competition and enforce market principles to ensure economic efficiency. Cross-border integration with other energy markets would also provide third party access to monopoly networks.

Municipal services: *there is significant scope for private involvement in the delivery of public services and in EU financed projects.*

As elsewhere in the region, the municipal sector in Lithuania remains fragmented and suffers from poor administrative capacity. Despite extensive investment and operational needs, there is limited private sector participation in municipal sectors including water and sewage, urban transport and in the development of state transport infrastructure. There is however significant private sector participation in district heating. With substantial fiscal pressures on municipal finances there is an increasing scope for private involvement in increasing efficiency in the delivery of public services. Municipal infrastructure is decentralised and commercialised.

Financial sector

Banking sector: *The financial sector is generally sound, although fast credit growth over recent years and the crisis have exposed the sector to heightened risks.*

The basic regulatory framework in the banking sector is in place but financial sector supervision requires better coordination between the institutions responsible for banks and non-bank institutions. The number of banks is stable with over 90 per cent of assets foreign-owned. Regarding market institutions and policies, privatisation has been finished, with state-owned banks having no asset share. A combination of low interest rates and a highly competitive banking sector contributed to an annual growth of domestic credit of 40.6 per cent at the end of 2007, with domestic credit reaching some 55 per cent of GDP. This has exposed the sector to heightened risks. More than half of all loans are in foreign currency and are mainly financed by foreign (Nordic) parent banks. In the current environment with falling asset prices, declining output growth and rising unemployment, asset quality and capital adequacy indicators are deteriorating. This will in particular put pressure on smaller local banks with no parent support. In recent years, the Bank of Lithuania has taken a number of measures to strengthen banks' capital bases, including urging banks to pay due attention to loan-to-value ratios and debt service ratios, broadening the collection of information in the credit registry and making public statements on risks related to the housing market. Nordic parent banks have been raising new capital to absorb expected credit losses. Efficient home-host country supervisory coordination has implied early identification of capital needs and rapid measures to support the banking system. Government support measures in home countries have not carried any restrictions in access to capital for foreign subsidiaries.

Equity markets: *Despite progress, availability of external equity capital even before the crisis is still scarce.*

Although the private equity fund sector remains small, there has been a renewed interest by private investors in the Nordic countries who appear increasingly committed to private equity investments in the Baltic States. Increased business activity by equity funds,

including offering a broader range of financial instruments, is needed to improve the visibility of the sector.

Enterprise sector

General industry: *while pressures on the labour market are weakening rapidly, policy measures are still needed to improve skill levels in the labour force and increase long-term competitiveness.*

Although the business environment remains one of the best in the region and labour costs in absolute levels are still low in comparison with other European Union countries, above-productivity wage increases in major industries in recent years has been putting significant pressure on overall competitiveness. Policy measures are needed to improve education and skill levels in the labour force, while also ensuring sufficient labour supply in the medium term. Expansion of private enterprises and completion of restructuring of former state owned companies, particularly in less developed regions, remain key issues.

SMEs:

Small and medium enterprises (SME) form the backbone of the Lithuanian economy and are crucial providers of employment and services, particularly in the poorer areas of the country. As credit growth slows and financing conditions deteriorate, it will be important to support the financing needs of SMEs. The business environment is relatively business-friendly. According to the 2009 World Bank's "Doing Business" report, starting a business requires seven different procedures and takes an average of 26 days, at a cost equal to 2.7 per cent of gross national income (GNI) per capita, lower than the average cost for OECD countries (4.9 per cent). Employment regulation is however relatively rigid and non-wage labour costs are higher than in the region and the OECD average.

2.4 Legal environment

Lithuania has generally achieved a fairly high level of compliance with international standards in relation to commercial laws. Lithuanian capital markets laws and regulations were found in high compliance with international standards by the 2007 EBRD Securities Markets Legislation Assessment, although enforcement rules and procedures could be improved (see Annex 6). In terms of company law and corporate governance, the 2008 EBRD Corporate Governance Sector Assessment also indicates an overall good level of compliance with the OECD Principles of Corporate Governance, even if certain improvements are still required (including with respect to the regulations applicable to the responsibilities of boards of directors). While further improvements may be needed to promote Public-Private Partnerships, the Concessions Law adopted in 2003 (with EBRD's technical assistance) is in very high compliance with international standards and one of the best drafted laws in EBRD's countries of operation. In terms of secured transactions, the Lithuanian legal framework is overall efficient, "user-friendly" (with a centralised and computerised registrar of movables pledges and immovables mortgages accessible via the internet) and well implemented although again certain improvements may be advisable as mentioned in Annex 6.

2.5 Environmental issues

Lithuania has implemented EU *acquis* in all areas to date except in areas where transitional periods were agreed, including:

- urban waste water treatment (up to December 2009)
- integrated pollution prevention and control (IPPC) for certain large combustion plants (up to 2015)

Lithuania's sustainable development goals and priorities are based on implementing National Strategy for Sustainable Development which extends to 2020 and takes into consideration EU's Sixth European Community Environment Action Programme for 2001-2010.

3. STRATEGIC ORIENTATIONS

This strategy will remain in accordance with the strategic outline for the years 2006 – 2010 agreed upon in Capital Resources Review 3, while also addressing the crisis needs in Lithuania and across the region, without questioning graduation.

3.1 Bank's priorities for Strategy period

In the current environment of a contracting economy and reduced lending by commercial banks, EBRD support for the financial sector and viable, nationally important projects especially in the energy sector is important in order to maintain already achieved levels of transition. This will be reflected in the Bank's operational priorities.

In an attempt to respond to the worsening external environment in a manner consistent with the analysis of Lithuania's remaining transition challenges, the Bank's immediate focus will be to respond to the exceptional economic circumstances by focusing on the following critical areas:

- **Strengthening the financial sector and ensuring the continued availability of credit to SMEs and the corporate sector.** This is best achieved through the provision of credit lines to local banks in close co-operation with other IFIs.
- **Considering investments in close collaboration with other IFIs to improve energy efficiency, support power links and selected new generation projects.** This will improve competitiveness by reducing the high energy intensity of the Lithuanian economy and contribute to improving energy security.
- **In light of the decrease in available debt financing, supporting local companies, most of which are SMEs, with equity capital.** This could be achieved through investing in equity and/or mezzanine funds.

3.2 Sectoral challenges and Bank objectives

The Bank will continue to focus on improving the competitiveness of enterprises and the diversification of energy sources in Lithuania. The sectoral challenges and objectives outlined below would be pursued once the effects of the credit crisis have subsided and the commercial bank market has returned to normal operation.

3.2.1 Financial Sector

Crisis Response/Transition Goals

Financial intermediation in Lithuania remains low, particularly to the SME sector. There is a lack of equity and mezzanine capital to support economic growth.

Operational Priorities

Crisis response measures:

- Immediate crisis response focuses on providing long term capital and/or equity to selected banks to support their lending to the corporate sector, particularly to the SMEs.

Other priorities:

- Selectively commit capital to new equity or mezzanine funds, mainly those focusing on SMEs.

3.2.2 Enterprise Sector

Crisis Response/Transition Goals

Improvements in public administration and judiciary are key remaining issues in the enterprise sector and corruption is still affecting the business environment. Increased business activity by equity funds, including offering a broader range of financing instruments, is needed. Expansion of private enterprises, particularly in less developed regions, is important. A coherent government strategy to invest in education, science and technology is necessary in order to identify and develop Lithuania's core competencies for the future.

Operational Priorities

Crisis response measures:

- Support necessary investments to improve competitiveness and growth in selected cases where commercial financing is not available or sufficient.

Other priorities:

- Provide long-term debt and equity to companies to support their growth, environmental investments and/or cross-border investments or that require restructuring or corporate governance support.

3.2.3 Infrastructure and Energy

Crisis Response/Transition Goals

There is limited private sector participation in municipal sectors particularly water and sewage, urban transport and in state transport infrastructure. There are significant unnecessary operating costs due to heat losses from municipal-owned heating networks and buildings and privatised industrial enterprises. The privatisation of one of the two electricity distribution companies is on hold. The closure of INPP is a key challenge and after closure Lithuania will be reliant on natural resources imported from Russia for most of its energy generation needs.

Operational Priorities

Crisis response measures:

- Contribute to energy security by supporting nationally important energy investments, including renewables and power links, in close collaboration with other IFIs and commercial banks.
- Support energy efficiency investments through providing long term capital to commercial banks in co-operation with state authorities and other IFIs.
- Support commercial banks' lending to EU co-funded projects.

Other priorities:

- Support the development of alternative energy sources, in particular renewable energy.
- Encourage, where appropriate, private sector participation in the financing of large-scale energy and transport infrastructure as well as municipal infrastructure. Where possible these projects will be complemented with EU funding.

3.3 Portfolio management challenges

The Bank will structure its portfolio management in such a way that it is able to improve the current quality of the portfolio and ensure that project monitoring by the Vilnius Resident Office staff is proactive and of high standard.

4. ACTIVITIES OF EU, OTHER IFIs AND CO-OPERATION WITH EBRD

- **European Union (EU):** In the period of 2007 – 2013 Lithuania was allocated over EUR 6.7 billion from the Structural Funds, which will be channelled to the following Programmes: economic growth (45.7 per cent), development of human resources

(13.8 per cent), promotion of cohesion (39.8 per cent) and technical assistance (1.4 per cent).

- **European Investment Bank (EIB):** Since 2006 EIB has committed financing to an amount of EUR 1,256 million in Lithuania. The financed investments are EUR 43 million to finance Lithuanian Railways' purchase of new locomotives, EUR 5 million to Swedbank (Lithuania) and EUR 20 million to SEB Vilniaus Bankas to be onlent madcap corporates, EUR 10 million under a Global Loan to Nordea and EUR 15 million also under a Global Loan to DnB Nord Bankas. A signed framework of EUR 1,132 million to co-finance EU funds was signed in early 2009
- **International Monetary Fund (IMF):** Lithuania joined the IMF in May 1992. The latest Stand-by facility expired successfully in March 2003 with all performance criteria met. Lithuania has not had financial obligations to the IMF since February 2005. The Article IV consultations are held on the standard 12-month cycle. The last staff visit was completed in June 2009.
- **World Bank (WB):** Since Lithuania joined the World Bank in 1992, the World Bank support has helped the government implement structural reforms and build capacity at the sector and local levels, improve SME access to finance, and tackle the cleaning up of the Baltic Sea. To date, World Bank's commitments have totalled US\$ 490.8 million for 17 operations. Given the differing objectives and sectoral priorities of the respective institutions, the Bank has not collaborated on any concrete projects with the World Bank in Lithuania. In September 2006 Lithuania graduated from World Bank borrower status.
- **International Finance Corporation (IFC):** Since Lithuania joined the IFC in 1993, the IFC has invested US\$ 66 million from its own account in five projects in the food processing, textile, finance, construction materials, and electronics industries. In addition, the IFC completed a number of donor-funded technical assistance projects, focused on improving the investment climate, developing small and medium enterprises, and helping with the leasing sector and privatization. Following Lithuania's accession to the EU, IFC's role in the country has changed and its focus has shifted to the regions, sectors, and projects where private financing remains limited, emphasizing socially and environmentally sensitive sectors. The Bank has co-invested with IFC in Drobe Wool, a Lithuanian textile company.
- **Nordic Investment Bank (NIB):** Lithuania became a member of NIB in January 2005. However the NIB has been active in Lithuania already before this through the Baltic Investment Programme. Since 2006 NIB has financed four projects in Lithuania: A loan programme of EUR 5.5. million with Siauliu Bankas for onlending to SMEs, a EUR 15 million loan for AB Rytu Skirstomieji Tinklai to finance investments in the company's electricity distribution network, a EUR 10.3 million loan to UAB Vilniaus vandenys to finance the construction of a sludge treatment facility and a EUR 20 million loan to City of Vilnius to finance road building and the upgrade of the city' public transport fleet.

- **Kreditanstalt für Wiederaufbau (KfW):** KfW has provided financing to support the private enterprise sector through SME development. In addition, KfW has financed projects for improving energy efficiency through building rehabilitation as well as part of a EUR 90 million project to develop a PET production plant in Klaipeda. Since 2006 KfW has signed no new investments in Lithuania. The Bank has not collaborated on any concrete projects with KfW in Lithuania.
- **Council of Europe Development Bank (CEB):** Lithuania became a member of CEB in January 1996. In 2008 CEB signed a loan with SEB bank for an amount of EUR 100 million to finance social sector investments in the Baltic states through SEB's subsidiaries, SEB Vilniaus Bankas in the case of Lithuania. In 2007 CEB approved a project of EUR 10 million with Siauliu Bankas to create or preserve viable jobs in SMEs throughout Lithuania. In June 2009 CEB approved a of EUR 130 million for development of social infrastructure in Lithuania.

ANNEX 1: COMMITTED PROJECTS PER YEAR

As of 31 April 2009 – EUR million

Year	Op Name	Regional/Direct	Total Project Value	EBRD Finance	Debt	Equity
	Lithuania Energy Sector Emergency Investment Project	Direct	33.0	33.0	33.0	0.0
1992	1		33.0	33.0	33.0	0.0
	Lithuanian Development Bank Capital Investment	Direct	5.0	0.9	0.0	0.9
	Transport Project	Direct	39.4	16.0	16.0	0.0
	First NIS Regional Fund	Regional	0.6	0.3	0.0	0.3
	Telecom Development International	Direct	50.2	21.2	21.2	0.0
1994	4		95.2	38.4	37.2	1.2
	East European Food Fund	Regional	4.8	1.0	0.0	1.0
	Paroc Silikatas	Direct	19.6	5.4	5.4	0.0
	Vilniaus Bankas (credit line)	Direct	7.9	6.9	6.9	0.0
	Baltic Investment Fund	Regional	5.8	1.6	0.0	1.6
	Kaunas Water and Environment	Direct	79.3	12.7	12.7	0.0
	Vilniaus Bankas (Lines of Credit)	Direct	6.4	6.4	6.4	0.0
	Vilniaus Bankas (Equity)	Direct	2.5	2.5	0.0	2.5
1995	7		126.3	36.5	31.4	5.1
	Sampo Bankas (formerly LDB) (credit line)	Direct	8.0	2.8	2.8	0.0
	Via Baltica and Lithuania Road Project	Direct	102.2	19.7	19.7	0.0
	New Europe Insurance Ventures	Regional	1.5	0.1	0.0	0.1
	Lithuanian Development Bank Capital Increase	Direct	5.8	0.7	0.0	0.7
1996	4		117.5	23.2	22.4	0.8
	IO Fund - Wood Team Production	Direct	0.3	0.3	0.0	0.3
	PPF - Baltic - Vilksma	Direct	0.7	0.7	0.0	0.7
	Baring Communications Equity	Regional	1.9	0.4	0.0	0.4
	Baltic Small Equity Fund	Regional	4.2	1.9	0.0	1.9
1997	4		7.2	3.4	0.0	3.4
	Innova/98 LP	Regional	2.0	0.4	0.0	0.4
	PPF - Baltic - Trinyčiai	Direct	0.9	0.9	0.0	0.9
	PPF - Baltic - Utenos Trikotazas	Direct	3.9	3.9	0.0	3.9
	Vilniaus Bankas Subordinated Loan	Direct	9.2	9.2	9.2	0.0
	Nord/LB Lietuva (formerly LZUB) Subord Loan	Direct	13.6	11.0	11.0	0.0
	Vilniaus Bankas Subordinated Loan	Direct	10.2	10.2	10.2	0.0
	PPF - Baltic - Kauno Pieno Centras	Direct	8.1	8.1	0.0	8.1
	Dalkia - Litesko	Direct	12.8	4.4	3.5	1.0
1998	8		60.7	48.1	33.9	14.2
	Rokiskio Suris	Direct	10.0	8.7	0.0	8.7
	Vilniaus Bankas	Direct	75.0	25.0	25.0	0.0
	Carlsberg MPF - Svyturys	Direct	41.5	9.5	0.0	9.5
	Nord/LB Lietuva (formerly LZUB) Syndicated Loan	Direct	12.7	4.2	4.2	0.0
	Emerging Europe Capital Investors LDC	Regional	8.3	2.2	0.0	2.2
	Drobe Wool	Direct	23.7	8.1	7.0	1.1
1999	6		171.2	57.8	36.3	21.5
	LDB/LZUB Share Swap	Direct	4.8	1.6	0.0	1.6
	IO Fund - Lietuvos Draudimas (equity)	Direct	8.4	8.4	0.0	8.4
	Lietuvos Telekomas IPO	Direct	146.3	51.8	0.0	51.8

Year	Op Name	Regional/Direct	Total Project Value	EBRD Finance	Debt	Equity
	PPF - Baltic - Sonex	Direct	3.5	3.0	0.0	3.0
	PPF - Baltic - Alna	Direct	1.6	1.5	0.0	1.5
	Baltic Investment Fund III	Regional	18.0	3.3	0.0	3.3
	TBIH Financial Services Group N.V. (debt & equity)	Regional	1.3	0.8	0.1	0.6
	EU/EBRD Phase I - Ext. - Siauliu Bankas	Direct	5.0	5.0	5.0	0.0
2000	8		189.0	75.3	5.1	70.2
	DVI, Inc. (debt)	Regional	1.1	0.3	0.3	0.0
	Kaunas Water and Environment Project - Phase II	Direct	73.6	14.7	14.7	0.0
	Lithuania/Warehouse Receipt Programme-Siauliu Bankas	Direct	1.6	1.6	1.6	0.0
	Lietuvos Draudimas	Direct	16.0	5.3	0.0	5.3
	EU/EBRD Phase I - Baltic SME Fund	Regional	5.7	1.0	0.0	1.0
	Lithuania Railways (LG) Corridor IX Project	Direct	94.4	45.8	45.8	0.0
2001	6		192.3	68.7	62.4	6.4
	Askembla Growth Fund	Regional	17.5	6.0	0.0	6.0
	Heitman Central Europe Property Partners Fund II	Regional	3.8	1.1	0.0	1.1
	Danfoss Debt Facility for Industrial Energy Projects	Regional	0.3	0.1	0.1	0.0
2002	3		21.6	7.2	0.1	7.1
	City of Vilnius Municipal Infrastructure Project	Direct	8.5	7.0	7.0	0.0
	EU/EBRD Extension 4 - Hansa Capital	Regional	9.9	5.0	5.0	0.0
	Dalkia Litesko II	Direct	3.8	3.8	0.0	3.8
2003	3		22.2	15.8	12.0	3.8
	VP Market	Direct	35.0	35.0	35.0	0.0
	Polish Enterprise Fund V	Regional	0.9	0.9	0.0	0.9
	Kauno Autobusai	Direct	10.0	10.0	10.0	0.0
	NordLB Lietuva	Direct	3.3	3.3	3.3	0.0
	Europolis II	Regional	9.0	2.3	1.7	0.6
2004	5		58.2	51.5	50.0	1.5
	Siauliu Bankas equity	Direct	5.9	5.9	0.0	5.9
	Emerging Europe Convergence Fund II	Regional	3.6	3.6	0.0	3.6
	Siauliu Bankas credit line	Direct	12.0	5.0	5.0	0.0
	Minsk Retail Network	Regional	12.5	5.4	5.4	0.0
2005	4		34.0	19.9	10.4	9.5
	Kaunas Trolleybus Modernisation Project	Direct	15.0	10.0	10.0	0.0
	Siauliu Bankas equity - capital increase	Direct	1.5	1.5	0.0	1.5
	Siauliu Bankas second syndicated loan	Direct	12.0	4.0	4.0	0.0
2006	3		31.5	15.5	14.0	1.5
	Project Bella	Regional	243.5	5.0	0.0	5.0
	Clean Globe International Oil Spill Protection	Regional	25.1	7.3	7.3	0.0
	Clean Globe Oil Spill Investment (EQUITY)	Regional	0.7	0.7	0.0	0.7
	E ENERGIJA DISTRICT HEATING PROJECT	Regional	1.7	1.7	0.0	1.7
	Royalton Partners II	Regional	2.5	2.5	0.0	2.5
	EnerCap renewable energy financing vehicle	Regional	5.0	2.5	0.0	2.5
	Balcap Private Equity Fund	Regional	6.0	6.0	0.0	6.0
	E Energija District Heating Project	Direct	7.5	7.5	7.5	0.0
2007	8		292.0	33.2	14.8	18.7
TOTAL	74		1,451.9	527.5	366.0	164.9

ANNEX 2: NET CUMULATIVE BUSINESS BY INDUSTRY

As of 31st April 2009 – EUR million

Sector Team (SIC)	EBRD Finance	Debt	Equity	Private	State	Portfolio Ratio*	% Share of Commitments	Total Project Value
Corporate								
Agribusiness	33	14	19	33	0	100%	7%	66
General Industry	11	9	1	11	0	100%	2%	34
Property and Tourism	3	2	2	3	0	100%	1%	12
Telecoms Informatics & Media	76	19	57	76	0	100%	16%	428
Sub-total Corporate	123	44	79	123	0	100%	25%	540
Energy								
Natural Resources	8	7	1	8	0	100%	2%	26
Power and Energy	34	32	3	3	32	7%	7%	42
Sub-total Energy	42	39	3	11	32	25%	9%	68
Financial Institutions								
Bank Equity	18	0	18	18	0	100%	4%	41
Bank Lending	98	98	0	98	0	100%	20%	187
Equity Funds	41	0	41	41	0	100%	8%	94
Non Bank Financial Institutions	11	5	6	11	0	100%	2%	28
Sub-total Financial Institutions	169	104	65	169	0	100%	35%	350
Infrastructure								
Municipal & Env Inf	75	69	6	17	58	23%	16%	235
Transport	76	76	0	0	76	0%	16%	218
Sub-total Infrastructure	151	145	6	17	134	11%	31%	452
LITHUANIA TOTAL	485	331	154	319	165	66%	100%	1,410

Direct	416	317	99	250	165
Regional	69	14	54	69	0

Non-Sovereign	347	193	154	300	47
Sovereign	138	138	0	19	119

PRIVATE	319	165	154	319	0
STATE	165	165	0	0	165

DEBT	322	322	0	157	165
EQUITY	154	0	154	154	0
GUARANTEE	8	8	0	8	0

ANNEX 3: SELECTED ECONOMIC INDICATORS

	2003	2004	2005	2006	2007	2008 <i>Estimate</i>	2009 <i>Projection</i>
Output and expenditure							
	<i>(Percentage change in real terms)</i>						
GDP	10.2	7.4	7.8	7.8	8.9	3.0	-18.0
Private consumption	10.4	11.9	12.2	10.6	12.4	4.7	na
Public consumption	4.1	8.2	3.5	3.7	3.3	4.3	na
Gross fixed capital formation	13.7	15.7	11.2	19.4	20.8	-6.1	na
Exports of goods and services	6.9	4.4	17.7	12.0	4.3	11.3	na
Imports of goods and services	10.4	14.9	16.4	13.7	11.6	10.0	na
Industrial gross output	17.2	9.9	7.7	10.6	9.8	1.5	na
Agricultural gross output	7.4	-0.5	2.0	-10.0	13.2	1.5	na
Employment¹							
	<i>(Percentage change)</i>						
Labour force (end-year)	0.7	-1.3	-0.9	-1.2	0.9	0.7	na
Employment (end-year)	2.3	-0.1	2.6	1.7	2.3	-0.9	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	12.4	11.4	8.3	5.6	4.3	5.8	na
Prices and wages							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	-1.1	1.2	2.7	3.8	5.7	11.1	4.1
Consumer prices (end-year)	-1.3	2.9	3.0	4.5	8.1	8.5	0.0
Producer prices (annual average)	-0.4	6.1	11.4	7.6	7.0	18.4	na
Producer prices (end-year)	-0.2	6.8	13.5	2.8	19.4	-6.8	na
Gross average monthly earnings in economy (annual average)	5.8	7.2	11.0	17.2	20.5	19.4	na
Government sector							
	<i>(In per cent of GDP)</i>						
General government balance	-1.3	-1.5	-0.5	-0.4	-1.0	-3.2	-9.0
General government expenditure ²	33.2	33.3	33.3	33.6	34.9	37.2	na
General government debt	21.1	19.4	18.4	18.0	17.0	15.6	na
Monetary sector							
	<i>(Percentage change)</i>						
Broad money (M2, end-year)	18.2	24.1	35.5	21.5	21.4	-0.4	na
Domestic credit (end-year)	37.8	32.0	56.1	34.9	40.6	17.4	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	30.8	34.7	40.9	43.3	44.3	38.8	na
Interest and exchange rates							
	<i>(In per cent per annum, end-year)</i>						
Interbank interest rate	4.3	3.0	3.3	4.5	5.0	3.0	na
Treasury bill rate (3-month maturity)	2.6	2.2	2.4	2.9	4.2	4.0	na
Deposit rate	1.3	1.2	2.4	3.0	5.4	7.6	na
Lending rate	5.8	5.7	5.3	5.1	6.9	8.4	na
	<i>(Litai per US dollar)</i>						
Exchange rate (end-year)	2.7	2.5	2.8	2.6	2.3	2.5	na
Exchange rate (annual average)	3.1	2.8	2.7	2.8	2.5	2.4	na
External sector							
	<i>(In millions of US dollars)</i>						
Current account	-1,278.5	-1,724.4	-1,831.4	-3,218.4	-5,692.3	-5,628.7	330.0
Trade balance	-1,704.3	-2,382.3	-2,916.3	-4,209.6	-5,873.7	-5,568.1	-530.0
Merchandise exports	7,658.2	9,305.3	11,775.8	14,151.8	17,161.6	23,736.9	16,170.0
Merchandise imports	9,362.5	11,687.6	14,692.0	18,361.4	23,035.3	29,304.9	16,700.0
Foreign direct investment, net	142.0	510.4	689.0	1,550.7	1,408.6	1,459.4	980.0
Gross reserves, excluding gold (end-year)	3,485.4	3,519.0	3,919.5	5,672.3	7,593.2	6,265.9	na
External debt stock ³	8,337.8	10,471.6	12,560.3	18,957.1	30,097.4	32,468.5	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	3.9	3.2	2.8	3.3	3.4	2.2	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	16.6	14.9	16.6	16.9	17.5	na	na
Memorandum items							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	3.5	3.4	3.4	3.4	3.4	3.4	na
GDP (in millions of litai)	56,959.4	62,697.9	72,060.4	82,792.8	98,138.7	111,498.7	95,177.5
GDP per capita (in US dollars)	5,391.4	6,564.8	7,731.4	8,861.5	11,524.4	14,073.5	na
Share of industry in GDP (in per cent)	28.3	29.9	29.7	29.6	29.4	28.9	na
Share of agriculture in GDP (in per cent)	4.5	4.2	4.4	3.9	4.0	4.0	na
Current account/GDP (in per cent)	-6.9	-7.6	-6.9	-10.7	-14.6	-11.9	0.9
External debt - reserves (in US\$ million)	4,852.4	6,952.6	8,640.7	13,284.9	22,504.1	26,202.6	na
External debt/GDP (in per cent)	44.8	46.4	47.6	63.0	77.4	68.7	na
External debt/exports of goods and services (in per cent)	87.4	89.1	84.4	106.6	142.1	113.5	na

¹ Data based on the population census.

² General government expenditure includes net lending.

³ Includes non-resident currency and deposits and loans to foreign subsidiaries.

ANNEX 4: STRUCTURAL CHANGE INDICATORS

Lithuania: Structural and institutional change indicators

	2003	2004	2005	2006	2007	2008	2009
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	12.7	13.3	13.7	16.5	na	na	na
Private sector share in GDP (in per cent)	75.0	75.0	75.0	75.0	75.0	75.0	na
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.3	0.7	0.8	0.8	na	na	na
Share of industry in total employment (in per cent)	20.7	20.1	20.1	19.7	19.5	na	na
Change in labour productivity in industry (in per cent)	15.5	13.2	5.0	10.7	8.6	na	na
Investment/GDP (in per cent)	21.9	22.7	23.9	26.3	30.5	27.1	na
<i>EBRD index of small-scale privatisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	na
<i>EBRD index of large-scale privatisation</i>	3.7	3.7	4.0	4.0	4.0	4.0	na
<i>EBRD index of enterprise reform</i>	3.0	3.0	3.0	3.0	3.0	3.0	na
Markets and trade							
Share of administered prices in CPI (in per cent)	19.6	17.1	15.4	14.1	13.5	na	na
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	1.0	1.0	1.0	na	na
Share of trade with non-transition countries (in per cent)	63.6	58.2	54.2	52.2	52.1	na	na
Share of trade in GDP (in per cent)	91.4	93.1	100.3	108.1	103.3	112.2	81.6
Tariff revenues (in per cent of imports) ³	0.5	0.5	0.4	na	na	na	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	na
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	na
<i>EBRD index of competition policy</i>	3.0	3.0	3.3	3.3	3.3	3.3	na
Financial sector							
Number of banks (foreign-owned)	13 (7)	12 (6)	12 (6)	11 (6)	14 (6)	na	na
Asset share of state-owned banks (in per cent)	0.0	0.0	0.0	0.0	0.0	na	na
Asset share of foreign-owned banks (in per cent)	95.6	90.8	91.7	91.8	91.7	na	na
Non-performing loans (in per cent of total loans)	2.6	2.4	0.7	1.0	1.1	na	na
Domestic credit to private sector (in per cent of GDP)	22.8	28.8	40.9	50.1	60.3	na	na
Domestic credit to households (in per cent of GDP)	4.2	7.1	12.0	17.9	24.4	na	na
Of which mortgage lending (in per cent of GDP)	3.4	5.5	9.0	12.6	17.2	na	na
Stock market capitalisation (in per cent of GDP)	16.9	26.1	31.4	32.3	24.3	na	na
Stock trading volume (in per cent of market capitalisation)	17.5	8.2	10.1	22.8	10.1	na	na
Eurobond issuance (in per cent of GDP)	0.1	5.0	3.0	4.2	3.9	na	na
<i>EBRD index of banking sector reform</i>	3.3	3.3	3.7	3.7	3.7	3.7	na
<i>EBRD index of reform of non-bank financial institutions</i>	3.0	3.0	3.0	3.0	3.3	3.3	na
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	23.9 (62.8)	23.8 (88.5)	23.4 (127.1)	23.2 (138.1)	23.6 (144.9)	na	na
Internet users (per 100 inhabitants)	20.1	22.3	25.8	31.7	39.3	na	na
Railway labour productivity (1989=100)	67.8	71.0	77.1	83.0	91.1	na	na
Residential electricity tariffs (USc kWh)	9.4	9.7	10.2	9.1	10.9	11.6	na
Average collection rate, electricity (in per cent)	91	97	99	99	99	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.3	4.7	5.6	na	na	na	na
<i>EBRD index of infrastructure reform</i>	2.7	2.7	2.7	3.0	3.0	3.0	na
<i>Electric power</i>	3.0	3.3	3.3	3.3	3.3	3.3	na
<i>Railways</i>	2.3	2.3	2.3	2.3	2.3	2.7	na
<i>Roads</i>	2.3	2.3	2.3	2.3	2.3	2.3	na
<i>Telecommunications</i>	3.3	3.3	3.3	3.7	3.7	3.7	na
<i>Water and waste water</i>	3.3	3.3	3.3	3.3	3.3	3.3	na

¹ There are controls for national security, defence and lotteries.

² There is full tradeability of non-agricultural land. Ownership of agricultural land, however, is constitutionally prohibited for foreigners and partially restricted for Lithuanian legal persons.

³ Refers to all taxes on imports excluding VAT and import duties.

ANNEX 5: POLITICAL AND SOCIAL ASSESSMENT

Lithuania continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank.

Political Context

Lithuania established a multiparty parliamentary democracy on the restoration of independence in 1991. The president, who is directly elected for a five-year term, is the head of state, responsible for foreign and security policy. The president is also responsible for appointing the prime minister, who is approved by parliament and in turn appoints a cabinet, subject to presidential approval. Executive power is shared between the president and the prime minister, with the president responsible for the appointment of judges while the prime minister oversees domestic policymaking and the implementation of laws adopted by parliament. The parliament (Seimas) has 141 deputies elected for a four-year term, 71 of whom are elected in single-member constituencies and the remaining 70 from national party lists, with a minimal threshold of five per cent for parties and seven per cent for coalitions. Independent Lithuania has held five presidential and five parliamentary elections, all of which have been deemed free and fair by the international community.

Since independence Lithuania's political system has been characterised by a high degree of fractionalisation, frequent government coalition breakdowns and highly fluid political party structures subject to frequent changes of personnel. Lithuania's political parties tend to be based on strong political personalities, rather than clear ideological or programmatic platforms, and parliamentary coalitions are often formed on the basis of party leaders' ability to work together, leading at times to coalitions with an ideologically broad range of parties. This cross-party consensus-based approach often hampers efficient and effective policymaking, although it also serves to involve a large number of parties in the policy process.

Since 1991, Lithuanian voters have alternated in their support between centre-right and centre-left and social democratic parties. The most recent parliamentary elections, in October 2008, continued this pattern, with the Social Democrats losing out to centre-right parties, the Homeland Union–Lithuanian Christian Democrats (TS-LKD) in particular. TS-LKD secured a plurality of just less than 20 per cent of the party list votes as well as 27 single-mandate seats to receive a total of 45 seats in the 141-seat parliament. The Social Democrats were beaten into second place with less than 12 per cent of the party list vote and a total of 25 seats. The head of TS-LKD, Andrius Kubilius, was nominated by President Valdas Adamkus for the Premiership and approved by the Seimas on 27 November. Kubilius then proceeded to form a right-leaning coalition with three smaller parties: the newly established National Resurrection Party (TPP), led by the actor and television personality Arūnas Valinskas, with 16 parliamentary seats; the relatively new Liberal Movement (LS), founded in 2006, which took 11 seats in its first parliamentary election; and the Liberal and Centre Union (LCS), led by journalist, businessman and

former Mayor of Vilnius, Artūras Zuokas, with eight members of parliament. The coalition thus enjoys a relatively comfortable majority of 80 seats in the Seimas.

Despite this majority, however, the coalition has come under strain as the global financial and economic crisis began to hit Lithuania with greater force, with real GDP growth slowing to just 3.0 per cent in 2008 and the economy forecast to contract by almost 18 per cent in 2009. Growing social discontent and the need for policy measures to address both the immediate risks to macroeconomic and financial sector stability, including cutting public sector wages and containing the budget deficit, have led to significant disagreements among the four-party coalition, particularly over tax, education and social policy reforms backed by Prime Minister Kubilius. Two of the coalition partners, TPP and LCS, in April 2009 formed a formal united parliamentary bloc, and are threatening to block the TS-LKD-led package of anti-crisis measures.

The election in May 2009 of Dalia Grybauskaitė to the presidency with almost 70 per cent of the national vote looks likely to help overcome some of the tensions which have been brewing within the ruling coalition. Grybauskaitė has long been widely respected in Lithuania as a highly effective administrator, a reputation that was further strengthened by Grybauskaitė's five-year stint as European Commissioner for Financial Programming and the Budget. Although she is a political independent, Grybauskaitė's candidacy was backed by the premier's TS-LKD, and her policy prescriptions for addressing the economic crisis, particularly the need for strong fiscal restraint, are in many ways consonant with those of Prime Minister Kubilius. Her positive reputation in Lithuania combined with her very strong popular support at the polls are likely to mean that Grybauskaitė takes an active role in driving the anti-crisis and economic reform agenda thereafter.

Integrity Issues

Corruption in Lithuania is a moderate problem. According to Transparency International's Corruption Perceptions Index (CPI) – an 'index of corruption indices' – in 2008 Lithuania scored 4.6 out of 10 (with 10 representing the lowest level of corruption). This marked a slight deterioration from the score of 4.8 that Lithuania received from 2001 until 2007, indicating that not only had the country made negligible progress in combating corruption (or at least the perception thereof), but had in fact fallen behind comparable countries in the CEB region, some of which had improved on the Corruption Perceptions Index over that period. As a result, Lithuania fell from the 4th ranked transition country in 2001 to the 6th ranked in 2007 and 7th ranked in 2008. These findings on corruption are echoed by the World Bank's Worldwide Governance Indicators: Lithuania is ranked sixth among the CEB countries on the Rule of Law index and seventh on the Control of Corruption index.

The more detailed Business Environment and Enterprise Performance Survey (BEEPS), carried out jointly by the EBRD and World Bank in 1999, 2002, 2005 and 2008, paints a more mixed picture of the Lithuanian business environment. Although firm managers have reported a general and consistent reduction in the obstacles to the operation and

growth of their firms across most aspects of the business environment, business licensing, inspections and administrative corruption remain challenges. These findings echo the survey-based findings of the non-governmental sector, in particular Transparency International-Lithuania, which has carried out extensive analytical work in this area over a number of years. These perceptions are no doubt strengthened by the number of high-level political corruption scandals that have been revealed in recent years.

Social Conditions

Population

According to Statistics Lithuania, Lithuania's population was 3.34 million at the beginning of 2009, down approximately 9.1 per cent since 1990. The population decline is attributable to a combination of natural decrease – owing in part to the deterioration in living conditions in the early 1990s – and net migration outflows. Emigration from Lithuania increased sharply following accession to the European Union in 2004, from 22,700 in 2003 to more than 48,000 in 2005, although the number then declined to reach 26,500 in 2007. Statistics Lithuania estimate that as many as 400,000 mostly young Lithuanians currently reside abroad, while another 300,000 are forecast to emigrate by 2030. However, the global economic crisis is likely to result in an increase in the rate of return of Lithuanian emigrants, bringing back valuable professional experience and skills to the domestic economy. Like most EU member countries, Lithuania has an ageing population demographic, which has led the government to raise the retirement age twice; from 2006 the retirement age has been 65 for men and 60 for women.

Minorities

Lithuania is the most ethnically homogeneous of the Baltic countries: according Statistics Lithuania's estimates based on the 2001 census, at the start of 2008 84.3 per cent of the population was ethnically Lithuanian. In addition there are 115 nationalities in Lithuania, of which the largest are the Poles (6.2 per cent), Russians (5.0 per cent), Belarussians (1.1 per cent) and Ukrainians (0.6 per cent).

Lithuania's legal framework for the protection of minority rights is well developed. Lithuania's citizenship law of 1989 allowed all residents to apply for naturalisation, regardless of ethnicity. Important amendments to a number of laws – including the Penal Code, the Civil Code, the Labour Code and the Law on Education – were undertaken in the first half of this decade to comply with relevant EU legislation as well as the UN Convention on Elimination of All Forms of Racial Discrimination. In early 2002 the Ministry of Education approved new regulations permitting the use of minority languages as the primary language of education in compulsory education, and there is an expansive network of state-funded Polish- and Russian-language primary and secondary schools. In 2003, the Seimas Commission for Human Rights prepared a Programme to Combat Intolerance, Racism, Xenophobia and Homophobia as part of the government's National Action Plan for the Protection and Promotion of Human Rights. Despite these efforts by the authorities, concerns remain about the treatment of the small Roma minority.

Poverty

Sustained economic growth of above seven per cent per annum from 2001 – 2007 and relatively low levels of income inequality in Lithuania have resulted in comparatively low levels of poverty. According to the World Bank's survey-based estimates, less than 3.0 per cent of the population lives on less than US\$ 2.15 per day (calculated in US\$ purchasing power parity terms), while approximately 20.0 per cent of the population was 'at-risk' of poverty when taking into account social transfers, according to end-2007 figures from Statistics Lithuania. However, the severe economic crisis and rapid rise in unemployment in Lithuania are clearly leading to a rise in poverty rates. Rural poverty remains a particular issue of concern, with the 'at-risk' category rising as high as 40.0 per cent in some rural areas, and particularly as the growth in disposable income is higher in urban than rural areas.

Education

Education in Lithuania is compulsory from the age of six to 16, and more than 50 per cent of Lithuanian children attend pre-school before the age of six. From the age of 16 children in Lithuania can attend either vocational or comprehensive upper secondary schools, and vocational education has been restructured to more flexibly meet the needs of the labour market. Secondary school enrolment hit a low in 1993, but recovered quickly during the 1990s to reach more than 90 per cent in 2004, in part due to the growing recognition of the importance of educational qualifications for the labour market. Continuation to tertiary education has increased dramatically since 1996, to reach more than 200,000 students in 2007, although the lack of commensurate increases in tertiary education spending (from a low base) has also led to low wages and concerns about corruption in Lithuanian universities.

Health

Health indicators declined precipitously in the early 1990s, in the wake of Lithuania's economic collapse. Infant mortality reached a peak of 16.3 deaths per 1,000 live births in 1992, and then fell rapidly to reach 5.9 per 1,000 live births in 2007, according to the World Health Organisation (WHO) and Statistics Lithuania. In relative terms, this is more than twice as high as the infant mortality recorded in Sweden but on a par with Poland and significantly better than that recorded in Latvia. Life expectancy also fell sharply in the early 1990s but has since recovered: life expectancy for women, currently 77.2 years, is converging toward the EU mean, although for men it remains low, at 64.9 years, and has been falling over recent years (from 66.8 years in 2000). This is largely attributable to continued high levels of alcohol consumption. High levels of alcohol consumption are also correlated with the suicide rate in Lithuania, which has been the highest in the world for almost a decade. Although the authorities have implemented policies to try to bring down the country's suicide rate, older men living in rural areas remain particularly vulnerable to self-harm.

Health system reforms were implemented in the mid-1990s, including a move away from the highly centralised Soviet system of tertiary care specialists toward greater emphasis on primary care and general practitioners. However, the number of general practitioners remains low by EU standards. The financing of the national health system was overhauled in 1997, with the introduction of employed-funded compulsory health insurance, administered by the State Patients' Fund independently from the Social Security Agency. The government remains committed to deepening the provision of primary care. However, as with higher education, the low wages in the health sector have led to high levels of emigration of professionally qualified medical staff, and corruption in the public health system remains a major challenge, with more than 50 per cent of patients reporting that bribe payments are made sometimes, usually or always in the public health system – one of the highest levels in the transition region – according to the 2006 EBRD-World Bank Life in Transition Survey.

Labour issues

Unemployment in Lithuania reached its post-independence high of 17.9 per cent (according to ILO methodology) in 2001. The unemployment rate then fell steadily, to approximately 11 per cent at the end of 2004, and then dropped rapidly to an annual average of just 4.3 per cent in 2007. However, from Q3 2008 the unemployment rate began to rise very rapidly as the impact of the economic crisis began to be felt in labour markets, almost doubling to 7.9 per cent in Q4 2008 and hitting 11.9 per cent in Q1 2009. In the longer term perspective, the structure of the labour force is rapidly converging to European norms, with the share of labour in the service sector gradually rising to reach almost 60 per cent in 2008, while the proportion working in agriculture and forestry has fallen to below 10 per cent, while the industrial sector has remained constant at around 28 per cent of the workforce. Trade unions in Lithuania are relatively weak, with a membership of less than 200,000, or 10 per cent of the workforce. Lithuania's 2003 Labour Law established collective bargaining as the main tool to regulate labour relations and gives employees the right to be represented in collective bargaining by unions or by a work council elected by a secret ballot. However, Lithuanian managers often determined wages without regard to union preferences, except in larger factories with well-organised unions. According to the International Trade Union Confederation, no employer has ever faced sanctions on the basis of anti-union discrimination.

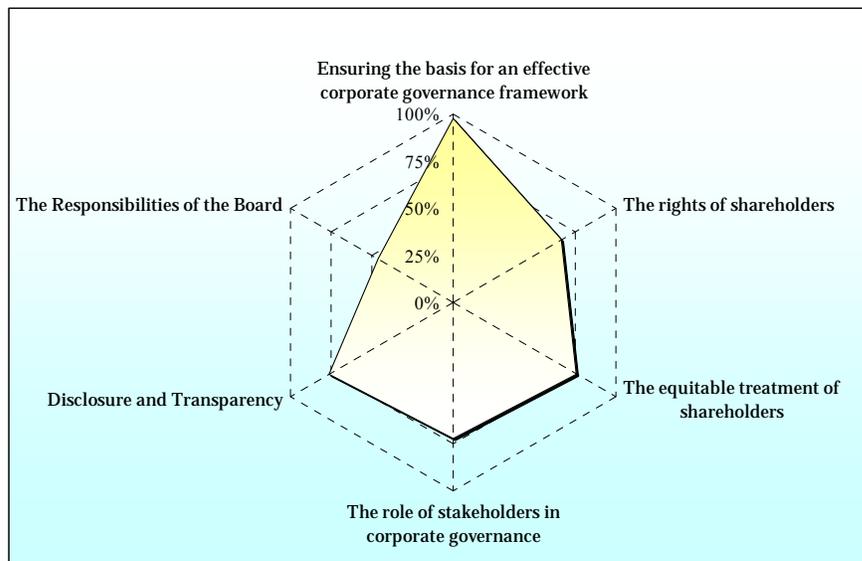
ANNEX 6: COMMERCIAL LAWS OF LITHUANIA

The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws “on the books” (also referred to as “extensiveness”) and the actual implementation of such laws (also referred to as “effectiveness”). All available results of these assessments can be found at www.ebrd.com/law. This annex presents a summary of the results for Lithuania, accompanied by critical comments of the Bank’s legal experts who have conducted the assessments.

Company Law and Corporate Governance

The corporate governance basic framework in Lithuania comprises the Civil Code (2001), the Law on Companies (2001), the Law on Securities (2007), and the Law on Markets in Financial Instruments (2007). The Vilnius Stock Exchange has developed a voluntary corporate governance code¹ for listed companies, which was approved on 26 July 2006 by the Lithuanian Securities Commissions and on 21 August 2006 by the board of the Vilnius Stock Exchange. Companies listed on the stock exchange are required to state their compliance with the code according to the so-called “comply-or-explain” rule.

Quality of corporate governance legislation – Lithuania (2008)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the ‘web’, the more closely the corporate governance laws of the country approximate these principles

Source: EBRD Corporate Governance Sector Assessment, 2008 assessment

In early 2008, the EBRD benchmarked the Lithuanian corporate governance legislation with the relevant international standards (i.e., the OECD Principles of Corporate Governance). The results indicated that Lithuania achieved a good level of compliance, but with some shortcomings (see chart above). In particular the regulation on the

¹ The Corporate Governance Code for companies listed on the Vilnius Stock Exchange is available on the EBRD website at: <http://www.ebrd.com/country/sector/law/corpgov/codes/index.htm>

responsibilities of the board needs to be improved.

In 2005, the EBRD launched a survey for testing the effectiveness of corporate governance (how the law works in practice). A case study dealing with related-party transactions was designed. The case study investigated the position of a minority shareholder seeking to access corporate information in order to understand if a related-party transaction has indeed been entered into by the company and on how it was possible to obtain compensation in case damage was suffered. The effectiveness of legislation was then measured according to four principal variables: complexity, speed, enforceability and institutional environment. The survey revealed that legislation in Lithuania is relatively effective but a series of weaknesses exist. Related-party transactions are not well detailed in the legislation and this might render the procedures complex and the burden of proof heavy. The time needed to conclude the procedures is generally too long and it can exceed two years. When turning the attention to the institutional environment, the survey revealed that the independence of statutory auditors and the experience of courts need to be improved.

Concessions

Lithuania lacks (at least in a clearly documented format) a general policy framework promoting public-private partnership (PPP). However, the way the Government recently approached concession legal framework reform shows its interest in promoting and using PPP in infrastructure and services.

The 2003 Concessions Law, as amended, (the “Concessions Law”) is very close to the internationally accepted standards in the area. The 2006 changes to the legislative framework (amending the Concessions Law, the Law on Local Self-Government, and the Law on Management, Usage and Disposal of State and Municipal Property) enhanced even further a solid legal environment for PPP.

The Concessions Law is one of the few laws in the region that includes in its definition the notion of "activities having a commercial component" which allows for a wide range of PPP structures (e.g., design, finance, construction, renovation and maintenance, etc.) applicable to healthcare, education, transport, energy, waste and waste water collection and management, among other sectors. The scope of application of the Concessions Law has been further clarified and serves well to complement the existing comprehensive definition of concessions.

Importantly, the Concessions Law provides for the possibility of setting up a special purpose company, controlled throughout the concession period by the concessionaire, either domestic or foreign, to implement the project. The provisions regulating the project agreement give clear guidance on the main issues to be covered yet remain sufficiently flexible, thus allowing the parties to freely negotiate its terms. According to the law, concessions should not last more than 25 years but shall be of a sufficient duration to allow depreciation of new infrastructure and return on investment while concession agreement must describe the degree of risk sharing between the concessionaire and the awarding authority.

The Concessions Law contains provisions assuring fair and transparent selection process: pre-selection of bidders, procedure for requesting bids, possibility of a two-stage procedure, publication of concession award, limited exceptions to concession award without competitive procedures, existence of review procedures and recourse in case of violation of the rules, etc. It is also one of the few laws in the region stating that a concessionaire has the right to create security over its property, rights and assets and that the parties are free to agree (subject to Lithuanian Civil Code) on the governing law applicable to the project agreement with a possibility of international arbitration.

There is room for a further improvement of the Concessions Law. In particular, it currently does not provide for the establishment of a record of the key information pertaining to the concessionaire selection and the contract award. It does not regulate or refer to unsolicited proposals keeping silence on this important and sophisticated area. Despite these minor deficiencies, the Lithuanian Concessions Law is one of the best drafted concessions laws in the EBRD region of operations.

Insolvency

Bankruptcy and insolvency in Lithuania are governed by two laws: the Enterprise Bankruptcy Law and the Law on Restructuring of Enterprises (collectively, the “Insolvency Legislation”). Since the last assessment of insolvency laws by the EBRD in 2006, Lithuania amended both the Law of Restructuring of Enterprises (2007) and the Enterprise Bankruptcy Law (2008). EBRD will undertake a review of these latest amendments in an assessment to be completed in 2009. Subject to changes which may have been introduced under the 2007 and 2008 amendments, the existing EBRD assessment work has shown a need for improvement in various areas, including the timeline of a creditor’s right to initiate insolvency proceedings, the ‘balance sheet test’ for insolvency and the avoidance of pre bankruptcy transactions, as well as in the legislation regarding reorganisation.

Practical implementation of Lithuania’s insolvency legislation is an additional concern. The EBRD research work suggests that Lithuania’s insolvency system may suffer from being too formal, thus limiting access to the system for both debtors and creditors.

Secured Transactions

Lithuania is a success story in terms of secured transactions legal framework. Through a number of reforms in the late 90s and early 2000, the country has equipped itself with an efficient and user-friendly legal and institutional framework. Few weaknesses remain, however, which could be addressed but it is not clear whether the government is committed to undertaking these adjustments.

The main source of law is the relevant provision of the 2001 Civil Code, completed by the Law on Establishment of the Hypothec Register adopted in June 1997; Instruction on Filling in the Mortgage, Compulsory Mortgage, Pledge and Compulsory Pledge Bonds,

approved by the Order no. 46 of the Minister of Justice dated 20 February 2002; and Regulations of the Hypothec Register, adopted by the Resolution no. 1246 of the Government dated 18 October 2001.

Security rights over movable property (except possessory charges), a number of other transactions which are “quasi” security interests (sales with the right of redemption, leasing agreements, and sales with reservation of title), as well as mortgages must be registered with the Hypothec Register. The Hypothec Register is operated by the Central Hypothec Agency that has 15 local offices at district courts. The registrars are supervised by the Ministry of Justice. The system is centralised, fully computerised and easily accessible through the Internet. All interested persons can search the data electronically, including the particulars of a charge. Records on mortgages over land and buildings are immediately transferred to the Real Estate Register, which database is interconnected with the Hypothec Register.

In case of default, secured movable assets are realised by the chargeholder using the method agreed between the chargor and the chargeholder, or if the parties did not agree, the charged assets are sold by the chargeholder at a public auction. Enforcement of mortgages, in contrast, takes place via public auction led by a mortgage judge or by mandatory administration. In both cases, enforcement is reported to work efficiently unless the debtor challenges the procedure.

Generally, the system for taking, perfecting and enforcing security over movable and immovable property has been carefully and thoroughly implemented and is working well. This is confirmed in all EBRD surveys. However, further improvements could be made to the regime. In particular:

- 1) there is uncertainty about describing generally the charged assets. Although the Civil Code provides that the charge can cover all types of movable assets, both present and future, so that in theory it would be perfectly possible to create a charge encompassing fluctuating pools of assets, and even the whole of the enterprise, in practice the procedure seems to require that all assets given as collateral must be specifically described and identified.
- 2) Similar restriction exists with respect of mortgages: should the mortgage secure a debt whose amount is not fixed but capped, the definition of the debt in the contract is stricter and the mortgage validity is limited to five years.
- 3) The registration procedure could be made more efficient by being streamlined and simplified. Currently, in order to register a charge with the Register, all transaction documents must be filed at the Register and reviewed, in addition to being previously certified by a public notary. In contrast, in order to register a quasi security interest, it is sufficient to give a simple notice to the Hypothec Register. A term of five working days is usually sufficient to carry out registration of a charge over movables, and it takes one to two weeks to register a mortgage.
- 4) The costs of creation of a security over movable are also comparatively high: currently, fees for registering a charge can amount to LTL 700 (approximately

EUR 200), including stamp duty and notarial fees. The filing of a quasi security interest, in contrast, is only LTL 20.

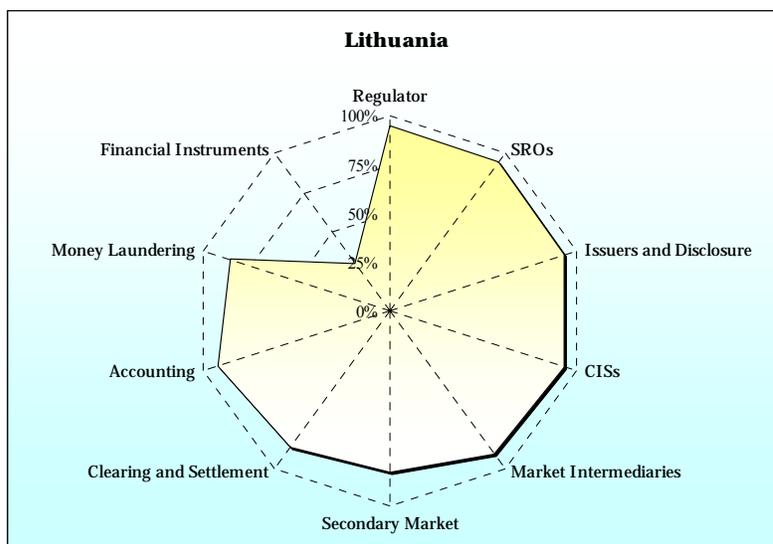
- 5) There is still a number of pending restitution claims which are not made public to third parties.

Securities Markets

In Lithuania the basic legislation on the securities market comprises the Law on Securities and the Law on Financial Markets Instruments, both enacted in early 2007. The Law on Securities regulates the procedure for the drawing up, approval and publication of prospectuses, ongoing disclosure practices, mandatory takeover bids requirements and the rights and duties of the Lithuanian Securities Commission. The Law on Financial Markets Instruments regulates the financial brokerage firms and the regulated markets. The securities market regulator is the Lithuanian Securities Commission, which is in charge for regulating and supervising the securities markets including pension funds.

As shown in the chart below, the 2007 EBRD Securities Markets Legislation Assessment, found Lithuania in “high compliance” with the Objectives and Principles of Securities Regulation published by the International Organization of Securities Commissions (IOSCO) showing only minor weaknesses in the legislation on bonds and derivatives.

Quality of securities market legislation – Lithuania (2007)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO’s *Objectives and Principles for Securities Regulations*. The fuller the ‘web’, the closer the relevant securities market legislation of the country approximates these principles.

Source: EBRD Securities Market Legislation Assessment 2007

In 2007 the EBRD launched a survey for testing the effectiveness of securities markets legislation (how the law works in practice). Respondents from leading law firms in the region were asked to comment on a hypothetical case study, advising an investor who lost its savings after buying shares through a bank, misled by erroneous information in the prospectus. In particular, respondents were asked to advise on effectiveness of prospectus disclosure requirements, private and public enforcement mechanisms and authority of the market regulator. The findings show a relatively effective securities markets framework but some weaknesses exist. Disclosure and financial reporting practices are sound, but

private enforcement mechanisms can be long and complex and overall, public enforcement mechanisms are deemed to be more effective than private ones. Lithuania needs to continue its effort to improve the quality of the law and strengthen the authority of the relevant institutions in line with the EU requirements and challenges.

Telecommunications

Institutional framework: The communications sector in Lithuania is currently regulated by the Communications Regulatory Authority (Ryšų Reguliavimo Tarnybą or RRT) and is governed by the Law on Electronic Communications 2004. The Ministry for Transport and Communications is the sector policymaker. This 2004 Law transposed the 2002 European Union (EU) regulatory framework on electronic communications and came into force on 1st May 2004 upon Lithuania's accession to the EU. RRT is an independent regulatory institution, formed in May 2001 in accordance with the then Law on Telecommunications, 1998, as part of Lithuania's efforts to harmonise with EU telecom *acquis*.

Market access and authorisations: The Lithuanian communications market was formally liberalised in January 2003 when local, domestic and international long-distance telephony were opened up to competition. As of September 2008 a total of 47 companies were registered to provide fixed-line public telephony services though incumbent fixed line operator, Lietuvos Telekomas (LT), still controls over 90 per cent of that market, with the remainder being shared amongst numerous alternative operators. There are three mobile network operators in Lithuania, all of whom are privately owned. There are also a number of Mobile Virtual Network Operator type operators providing services. Mobile teledensity significantly exceeds 100 per cent. The existing three GSM operators also hold 3G licences.

Significant market power (SMP): RRT has completed the first round of market analyses. LT and the three mobile operators are currently designated as having SMP in relevant markets.

Competitive safeguards: All the reference interconnection offers and standard network access agreements have been published and LT has also published revised reference offers for bitstream access, leased lines and interconnection. Ex-post general competition investigations are carried out by the national competition authority (NCA) based on complaints, which have been few so far. Throughout the investigations, the NCA cooperates with RRT on such issues as market definitions and economic data.

Local Loop Unbundling: The first agreement on unbundled local loops (LLU) was signed in September 2006. As of mid 2008, LLU was understood to have been taken up by two alternative operators. According to alternative operators, the use of the incumbent's network on a wholesale basis is not economically viable, because of high tariffs, reluctance to sell by LT and additional costs. In March 2007, RRT was understood to have adopted a formal dispute resolution decision on LLU resolving many of the issues identified by alternative operators.

Number portability: Lithuania is one of a small number of EU countries where number portability is free of charge to end-users. Though fully operational since February 2006, uptake has been slow in its first phase.

Universal service and consumer issues: In October 2007, RRT announced an open call addressed to all public electronic communication service providers inviting expressions of interest for provision of universal service or any of its elements without compensation.

Outlook: Significant advances in the implementation of modern, EU compliant, regulatory standards for communications in Lithuania and the resulting development of most sector markets continue. Though the dominance of LT in the fixed market continues, its significance should diminish as alternative technologies (such as the recently awarded WiMAX licences) take hold. Nonetheless RRT should ensure that the recurring interconnection issues with the incumbent's network are prioritised for intervention, in particular with the application of remedies dictated from the results of market analyses.

Assessment: In a 2008 assessment of the communications sector of EBRD Countries of Operation the sector regulatory regime in Lithuania was deemed to have "Full Compliance" when measured against international best practice.

ANNEX 7: THE IGNALINA INTERNATIONAL DECOMMISSIONING SUPPORT FUND

As part of the EU Accession process Lithuania has closed Ignalina Nuclear Power Plant (INPP) Unit 1 in December 2004 and committed to close Unit 2 by 31 December 2009 at the latest.

The agreed early closure of INPP and implementation of energy sector measures which are consequential to the closure of INPP are of high technical complexity and long-term natures. Implementation of the related projects represents a financial burden for Lithuania. The European Community recognised this challenge and agreed to complement the national efforts of Lithuania. In 1999, the European Commission initiated as part of EU Accession process a concerted multilateral funding programme. An important part of the Communities initiative is an EBRD-managed Ignalina International Decommissioning Support Fund (IIDSF). IIDSF activities are being implemented under a Framework Agreement dated 5 April 2001 between the Republic of Lithuania and the EBRD, which was ratified by the Seimas in July 2001.

To date the European Community and 15 additional countries contributed EUR 688 million to the IIDSF and further contributions are expected from the Community's financial assistance to Lithuania. Total commitments to grant financing or co-financing of projects amount EUR 679 million.

The purpose of the IIDSF is to finance or co-finance the provision of goods, works and services necessary:

(i) to support the decommissioning work at INPP

The overall INPP decommissioning should be done in a safe and efficient manner in order to ultimately reduce the hazards related to the operation of INPP and in the long term to release the site for other uses. Decommissioning is a long-term process of high technical complexity. It includes all the administrative and technical operations necessary to withdraw INPP from the list of licensed facilities. Therefore it is important to apply an integrated approach to the decommissioning process, so that design, engineering, management of investments in pre-decommissioning facilities, licensing and technical support issues are optimised. The main activities during the first phase following closure are the removal and intermediate storage of spent fuel, the processing of liquid and solid radioactive waste, and preparations for intermediate storage, as well as decontamination of systems and components, systems modifications and systems separations. Lithuania decided to apply the strategy of Immediate Dismantling for the decommissioning of INPP.

The current main grant financing commitments of the IIDSF relating to the INPP nuclear decommissioning support cover:

- Project management and engineering services in support of INPP's Decommissioning Service from 2001 onwards.
- Design and construction of a new interim storage facility for 17,000 RBMK spent nuclear fuel assemblies from Units 1 and 2.
- Design and construction of a new solid waste management and storage facility for 120,000 m³ short- and long-lived low and intermediate level radioactive waste.
- Design and construction of a reliable and environmentally friendly replacement heat and steam source for INPP and Visaginas (completed in 2005).
- Modernisation of INPP's technical documentation archive (completed in 2005).
- Free release measurement facility.
- Development of engineering, planning and licensing documentation, procurement of tools for dismantling and decontamination of INPP's equipment and systems and training of INPP's personnel.
- Reactive power compensation at the INPP power junction (completed in 2008).

(ii) to implement measures in the energy sector of Lithuania which are consequential to the closure and decommissioning of INPP and which would assist the necessary restructuring, upgrading and modernisation of the energy production, transmission and distribution sectors as well as to improve energy efficiency

The closure of INPP impacts on the development of the energy sectors of the country. Therefore implementation of measures to facilitate the necessary restructuring, upgrading and modernisation of the energy production, transmission and distribution sectors, as well as improvement of energy efficiency, is becoming increasingly important.

In order to support the development of relevant projects, in 2007 the EBRD commissioned with IIDSF grant financing the following two studies: "Lithuania – Power Sector Least Cost Expansion Plan"; and "Update review of the Eastern Gas Sector". The objective was to help the Government of Lithuania to make informed decisions on how to progress with the development of gas and electricity sectors in Lithuania. Both studies were accepted by the Ministry of Economy.

The current main grant co-financing commitments of the IIDSF relating to the development of the Lithuanian energy sector cover:

- Construction of a new 100 km gas pipeline from Pabrade to INPP and Visaginas (completed in 2005).
- Design and construction of new flue gas desulphurisation and dust collection plants for Boilers 7A, 7B and 8A of as part of an overall environmental and technical upgrading of the 1800 MW heavy fuel oil and gas fired Lithuanian Power Plant which will become the major Lithuanian power generator after closure of INPP (completed in 2009).

- Design and construction of a new 450 MW Combined Cycle Gas Turbine (CCGT) plant.
- Consultancy services in support of the development of the power interconnection between Lithuania and Poland (LitPol project).

The EBRD and Lithuania have developed a strong relationship in the implementation of the INPP decommissioning process and energy sector development. Subject to additional contributions to the IISDF and approval at the Assembly of Contributors, the EBRD will continue its cooperation with the Lithuanian authorities, INPP and the energy sector companies to define additional project proposals.