Toward Reform of the Lithuanian Economy

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Many of Lithuania's current economic problems were inherited from the grossly inefficient Soviet economic system whose influence will remain for years. In addition, Western governments have contributed to Lithuania's problems by erecting trade barriers against products that Lithuanian firms would most likely export. However, now that Lithuania is again an independent country its citizens cannot blame all of their economic problems on adverse external influences. If Lithuanian voters and policymakers refuse to carry out the economic reforms necessary for a prosperous market economy, they should be held responsible for the consequences. Lithuanians have been the victims of oppression for many years, but responsibility comes with freedom.

By the middle of 1994, Lithuania had been independent for over three years and its economy was in transition, but many symbols of the Soviet period remained visible. Most obvious to a foreign visitor was the architecture. There was the sharp contrast between the grace and beauty of the buildings in the Old Towns of Vilnius and Kaunas and the drab, high-rise, concrete structures built during the Soviet period. Environmental degradation was strikingly represented by the Chernobyl-type nuclear power plant at Ignalina. The contemptuous attitude of employees toward customers of state-owned enterprises, such as hotels and restaurants, represents the extreme subordination of consumer interests that characterized the old system.

Less tangible, but equally important, were the attitudes of many Lithuanian people toward their fellow citizens and toward Westerners. Many people suffered since 1940, and there remains a lingering bitterness toward any Lithuanians who may have benefitted from the Soviet system. One also detects resentment toward any Lithuanians who got "too rich too fast" since independence. Finally, the long period of Soviet colonialism that followed earlier periods of domination by Tszarist Russia, Poland, and Germany has left many Lithuanians with a fear of being dominated by foreigners, including those from the West. An overreaction to past Soviet domination may lead to nationalistic policies that would preclude mutually beneficial international trade and investment. Similarly, resentment toward people whose wealth is considered excessive or whose wealth is earned in a socially unacceptable way can lead to economic policies that stifle economic growth.

After fifty years of involuntary participation in the Soviet system Lithuania declared its independence in March 1990, and independence was generally recognized by September 1991, following the failed coup in the USSR. A mature political system with checks and balances among branches of government and a system of political parties has not yet developed.[1] Domestic political squabbles have resulted in the average tenure of prime ministers being less than one year. Disenchantment with the Vytautas Landsbergis presidency has brought about the anomalous electoral victory of Algirdas Brazauskas, the head of the former Communist Party. Not only did he win an election by an impressive

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margin, but independent public opinion polls show that he continues to be the most popular public figure by far. An unsettled political system makes it difficult to carry out prudent economic policy.

Under the Soviet system Lithuania was one of the wealthier republics. Per capita income in Lithuania in 1988 was third highest (after Estonia and Latvia) among the fifteen Soviet republics,[2] but it was poor relative to contemporary Western countries. The gap in income between Lithuania and comparable Western countries widened over time. Unfortunately, since independence real income has fallen every year beginning in 1990, including declines of 38 percent in 1992 and 35 percent in 1993 (see Table 1). For comparison, U.S. real income fell by less than 2 percent in the recession of 1990-91. The command economy is no longer in place, but neither is a market economy. Similar severe economic contraction has also occurred throughout the former Eastern bloc. Only Poland and Hungary experienced economic growth in 1993. Economic reform takes time and it remains to be seen whether the Lithuanian people are sufficiently committed to make the necessary economic reforms and sufficiently patient to wait for future benefits of reform. An alternative is a return to a regulated economy and an autocratic political system. Many reform measures have been put in place and others are being implemented, but many additional reforms are necessary to achieve a market economy.

TABLE 1

Real Income Growth and Inflation*

	Growth in Real Income (percent)	Inflation Rate (percent)
1989	1.1%	9.7%
1990	-3.0	16.1
1991	13.0	224.7
1992	-38.0	1020.0
1993	-35.0	189.0

*Real gross domestic product.

Source: *Lithuanian Weekly*, 5 April 1994

Incentives

Under the Soviet system all important decisions were made in Moscow, and enterprise managers were rewarded for little more than fulfilling quotas. Managers had no incentive to satisfy consumer demand in terms of either quantity or quality of products. Money prices were set by bureaucrats at levels that resulted in shortages, and the existence of shortages for most products made it difficult for consumers to influence producers. Since managers were not rewarded for earning profits, they had no incentive to restrain costs by using fewer inputs or engaging in technological innovation. Enterprises did not fail, and losses were paid out of government subsidies. Competition was discouraged as state enterprises were shielded from entry by new domestic firms, imported products, or new enterprises financed fully or partly by foreign investment.

The incentives facing workers were also perverse. Rewards for acquiring and retaining additional skills were negligible. Workers were not rewarded for superior productivity, nor were they punished for poor performance. Unemployment was not allowed, and workers were not free to change jobs or places of residence in search of greater rewards.

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Since independence, incentives have changed some, but many disincentives to economic improvement remain. In some cases decrees from Moscow have been replaced by heavy-handed regulation from Vilnius. Some privatization has occurred, but state-owned enterprises continue to dominate many industries.[3] In the public sector many workers retain their jobs, even though their employers lose money and the public enterprises have poor prospects of ever becoming profitable. In some cases where privatization has occurred, a government monopoly has simply been replaced by a private monopoly. Competition has been discouraged by a poorly developed capital market and by restrictions on foreign investment. Profitable export opportunities have been stifled by export quotas or licenses imposed by the Vilnius government. For example, private exports of copper and aluminum have been prohibited even though it is profitable to import from Russia and re-export to the West. Business taxes appear to be burdensome, although evasion is reported to be widespread.

Entrepreneurship is an essential function in a market economy, and the emergence of entrepreneurs is important for the development of a prosperous market economy in Lithuania. The scarcity of ethnic Lithuanian entrepreneurs in the past has been frequently cited,[4] and visitors to Lithuania since independence continue to report less market activity in Vilnius than in the other Baltic capital cities.[5] Fewer joint ventures with foreign firms have occurred in Lithuania than in Estonia or Latvia.[6] Attitudes of Lithuanians toward business and trade have been described as "negative," "ambivalent," or "reflective of Bolshevik thinking." An example of this attitude is the reluctance of some Lithuanians to sell assets to people with money, either because the seller may not approve of the source of the money or the seller is opposed to some people having more than others.[7] All countries have some people with these attitudes (including President Clinton and much of the U.S. Congress on certain days), so it is important to know how common they are in Lithuania. Strong evidence is hard to come by, but current laws limiting the amount of land that an individual can own and when an owner can resell land do reflect at least some ambivalence toward capitalism. Restrictions on foreign ownership have frequently been cited as a deterrent to foreign investment and President Brazauskas has proposed amending the Constitution to allow foreign ownership, but as of July 1994, the Parliament refused to approve. If economic policy does not reward entrepreneurship, entrepreneurs will not be forthcoming in Lithuania. Recent economic liberalization in China indicates that the amount of entrepreneurial activity in a country can be very responsive to incentives.

One approach to economic reform is to allow greater regional autonomy.[8] For example, a former mayor of Kaunas (Vilimas Ciurinskas) is part of a private group that has developed a detailed plan for a free trade zone and a research park in an area near the Kaunas airport. The plan is designed to combine the resources of universities and research institutes in the area with those of local firms in a way that would attract outside capital. In spite of the willingness of private entrepreneurs to risk their own capital, the government in Vilnius continues to block the proposal. Regional experiments like this proposal have been a major source of economic growth in China recently. On the subject of regional autonomy the government in Vilnius could learn much from the government in Beijing.

Legal Framework and the Development and Structure of Markets

Although individuals are now allowed to own real property and financial assets, many restrictions on ownership rights remain. There are restrictions on the amount of land owned by individuals and on when individuals can resell land that they obtain. These restrictions reflect resentment of excessive wealth accumulation by individuals and the way people acquire wealth. In particular, there is resentment toward speculative earnings. Restrictions also apply to the resale of investment checks resulting from the privatization of state-owned enterprises. Foreigners are not allowed to own land. All of these restrictions on the property rights of owners reduce the ability of people to borrow and inhibit the development of badly needed financial markets. If someone has unrestricted ownership rights to property, he or she can use that property as collateral to obtain a loan. However, an asset loses value as loan collateral as more limitations are placed on ownership rights.

Certain property rights have not yet been established. A decision was made to return agricultural land to its previous owners, but the process of determining the legitimate owner is a difficult and slow one, and it is expected to take years to complete. In the meantime, uncertainty about future ownership of land and other agricultural assets is delaying potentially profitable agricultural investments. Another example of vague or incomplete property rights is an ineffective bankruptcy law. A clear bankruptcy law allows a lender to estimate the value of property he or she will receive if a borrower defaults on a loan obligation In the absence of a law, a lender has no clear claim on a borrower's property, and the lender is less likely to make a loan. Again weak property rights interfere with the development of financial markets.

The development of a prosperous market economy in Lithuania requires the establishment and enforcement of comprehensive property rights. Owners must be allowed to use their property for any legal purpose that they choose. Thus, new owners of land should not be penalized if they do not immediately use their land in agricultural activity. Landowners must be allowed to rent their land to any interested tenant and for any use. Landowners must be allowed to sell their land at any time and to any buyer, including foreigners. Thus, people receiving land should not be required to hold it for five years before selling it. Owners should be allowed to bequeath land to their heirs. Finally, there should be no limits on the amount of land acquired by an individual. If these comprehensive property rights were established and enforced, land would be used in a more efficient way and financial markets would develop more rapidly in Lithuania.

Poor enforcement of property rights and laws is an additional barrier to the development of private markets. Theft, robbery, and extortion have become serious problems for businesses and individuals.[9] In some areas a majority of small businesses report that they have been threatened by extortionists who are loosely described as the "mafia." Some firms have hired their own private guards, but the additional cost is a disincentive to business. Relative safety is something that governments are expected to provide in civilized countries, and it is a fundamental feature of a healthy business climate.

A related problem is a complex system of taxes with high average tax rates. Businessmen publicly proclaim that if they paid all the taxes due under current law they would be driven out of business, and tax evasion is widespread. Similar tax problems have occurred in less developed countries, and they hinder economic growth without generating much tax revenue. An attempt to overcome this problem is a recent tax reform in Mexico that simplified the tax structure and lowered the average tax rate. As a result, the Mexican government collected more revenue than it did under the previous system of higher tax rates.

Competition is an important mechanism for imposing discipline on business firms. It forces managers to continue to search for a better technology and a better way to combine labor and capital in production. It also rewards managers for producing goods embodying characteristics that best satisfy consumers. A fundamental shortcoming of the Soviet system was the absence of competition in all aspects of the economy. An unfortunate feature of the Lithuanian economy in 1994 is the retention of many monopolies. Many state enterprises have retained their monopoly power, and, in some cases of privatization, private monopolies have simply replaced government monopolies. Poor access to capital is one source of discouragement to entry of new domestically owned private firms, and restrictions on foreign ownership have reduced competition from foreign-owned firms that might have good access to international capital markets. Additional competition is an essential component of economic reform, and free international trade is the simplest and most effective way to achieve competition.

Capital and Financial Markets

The most frequently cited problem by new Lithuanian businessmen is the lack of access to capital. Western firms seeking to finance a new project would either self-finance from previously earned profits or use financial markets to obtain external funds. Borrowing could take several forms, including bank loans, issuing bonds, or issuing stock. However, new Lithuanian firms have accumulated very little capital from the past, and financial markets in Lithuania are practically non-existent.

An important function of financial markets is that funds are channeled from the ultimate savers to the ultimate investors without requiring these two groups to find each other. Thus, investors can go directly to a bank for a loan, and savers can go directly to a bank to make a deposit. In the absence of banks and other financial institutions, managers of firms planning investment projects must find people who have accumulated savings. According to a Kaunas businessman, this search sometimes requires finding out who has become wealthy and contacting the person directly about a loan.

The state-owned banks inherited from the Soviet period are totally inadequate. They were not profit-motivated, and most of the outstanding loans on their books are not being repaid. They did not provide employees with skills necessary to perform in profit-motivated commercial banks; for example, the ability to evaluate loan applications. A related problem is that there are no credit histories for borrowers that banks could use in evaluating the default risk on loans.

Lithuanian financial institutions are brand new, and employees and customers are forced to learn fast. Lack of experience with commercial banks makes it difficult to distinguish between high-quality and low-quality institutions and even between fraudulent and legitimate firms. Rudimentary markets for stocks and bonds are just emerging. The National Stock Market Exchange opened in September 1993, but the volume of trade and degree of liquidity are small. The Lithuanian government sold its first state bonds in July

1994. Foreign currency is traded by banks, but financial assets such as foreign currency futures, options, and swaps, are practically unheard of.

The rudimentary state of financial markets is a special case of the generic problem of poorly organized markets of all kinds (goods and services, labor, etc.) in Lithuania. The delay in introducing the new currency until June 1993 contributed to the problem, and an inadequate legal structure (e.g., bankruptcy laws) is also part of the problem. Branches of foreign banks would add to competition, but government policy has discouraged the entry of foreign banks. For example, there are higher capital requirements for foreign banks than for domestic banks.

Another barrier to the development of financial markets is lack of knowledge by borrowers and the general public about an inflationary environment. In at least one incident, a lender's apartment was blown up because he charged an apparently exorbitant interest rate of more than 200 percent per year. However, when the inflation rate is 200 percent per year (as it was at the time) a lender must receive a money interest rate of more than 200 percent in order to earn any real return from the loan. At any money interest rate below 200 percent, the money repaid on a one-year loan would buy fewer goods and services than the money originally borrowed. If borrowers are unwilling to pay interest rates that incorporate expected inflation, they should not expect to find many willing lenders. In general, saving will not be forthcoming unless it is rewarded. A fundamental solution to the problem of the distortionary effects of inflation is a monetary policy by the Central Bank of Lithuania that results in more stable prices. Legal limits on interest rates or violent acts against usurious lenders are not productive solutions. The adoption of a currency board in April 1994 is a bold attempt to limit inflation.

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Agriculture

Agriculture is a large sector of the Lithuanian economy and it is a source of export earnings. In 1989 agricultural production was 25 percent of gross national product in Lithuania (18 percent in Estonia, 20 percent in Latvia, 2 percent in the United States) and livestock accounted for 69 percent of Lithuanian agricultural production.[10] Food processing is a major component of the industrial sector. Meat and dairy products are major exports and feed grain is imported. Petroleum and natural gas are major sources of imported energy.

Agricultural production was heavily subsidized under the Soviet system, and the removal of subsidies created a serious adjustment problem. The loss of subsidized energy made it too costly to continue to operate all the heavy machinery. The disappearance of cheap feed grain sharply increased the cost of producing meat and led to a decrease in the total number of animals on farms. At the same time the removal of subsidies has created a powerful incentive to find ways to conserve on energy and to change the nature of livestock operations. The scale of collective and state farms was extremely large.[11] Lithuanian farms were much larger than farms in Sweden and Finland in terms of land, workers, and animals per farm. For example, in 1988 the average Lithuanian farm had 284 workers, whereas the typical Swedish farm employed 1.8 workers and the average Finnish farm employed 1.1 workers.

The collective and state farms were far larger than optimum size. However, under current conditions in Lithuania the average farm may be smaller than optimum due to restrictions on land ownership and limited access to capital by new private farmers. The size of farms is reduced both by the limitation on land ownership per person and by the prohibition on foreign ownership of land. These restrictions are binding today since the machinery inherited from the Soviet system was designed for extremely large farms.

Food consumption was heavily subsidized, and the reduction in subsidies was a shock to consumers. With food subsidies in place the average Lithuanian consumer spent 35 percent of his budget on food, but by November 1992, after partial removal of subsidies, the food budget share rose to 64 percent.[12] The typical family had to make large sacrifices of other products in order to avoid a major decrease in food consumption.

Privatization of agricultural land that began in 1989 is the third major land reform in this century.[13] After 1940 privately owned agricultural land was expropriated by the Soviet government and converted into collective and state farms. Some farmers described this event as a "return to serfdom." In addition, thousands of farmers were deported to Siberia. In 1920 land was redistributed from large landowners, most of whom were German, Polish, and Russian, to small farmers. In the nineteenth century land reform followed the abolition of serfdom. Privatization of land is an essential component of the current economic reform, but one has to ask whether another method for assigning ownership to land would have been more effective. The process has been slow, and according to one estimate[14] it will take eight more years to complete the current program for assigning land. Every year of delay results in additional sacrifice of agricultural output.

Other problems in agriculture include continued monopoly in the supply of agricultural inputs and in processing and distribution of agricultural output. Many enterprises remain state-owned, and even when enterprises have been privatized, there is little competition. The government fixes the profit margin for state-owned enterprises. Certain laws and regulations stifle competition. For example in mid-1993 regional bakeries were still not allowed to purchase flour from sources with the best quality and the most favorable price. Regional milling monopolies like this were common in the mercantilistic system that Adam Smith criticized more than 200 years ago in his *Wealth of Nations*, and they are just as reprehensible today as they were in 1776.

One of the most significant current distortions in agriculture is the restriction of agricultural exports. Lithuanian producers have a traditional cost advantage in producing and exporting many agricultural products, but their own government is preventing them from earning valuable foreign exchange. The immediate reason for export licenses and quotas is a government pricing policy that keeps domestic prices below comparable world prices. For example, in January 1992 potatoes sold for 5 rubles in Vilnius, 11 rubles in Moscow, 14 rubles in Tallin, Estonia, and 22 rubles in St. Petersburg (see Table 2). This price gap would make it profitable to buy products in Lithuania at the subsidized price and resell them for a profit at the world price. The export restrictions are in place to prevent these products from disappearing from the Lithuanian market. As of April 1991 forty-four commodities were subject to export licensing or quotas.[15] The motive for domestic price controls is to help domestic processors and consumers, but the unintended side effect is to punish some of the most efficient producers in the country. The pricing policy invites smuggling and bribery of government officials. It also provides a profit opportunity for members of the mafia who have special skills in illegal activity.

Lithuanian agricultural exports also face external barriers. The United States, Europe, and Japan all have highly protectionist agricultural trade policies, and some of their highest rates of protection apply to meat and dairy products, Lithuania's major exports. The United States and the European Union have subsidized exports of dairy products. Lithuania has applied for full membership in the European Union, but an associate membership with restrictions on agriculture was approved in July 1994. It is ironic that Western countries spent billions of dollars on defense expenditures to bring about the downfall of communism, but their trade policies make it more difficult for countries like Lithuania to become prosperous capitalistic countries. Comprehensive trade liberalization such as the Uruguay Round of negotiations sponsored by the General Agreement on Tariffs and Trade would provide Lithuanians access to more markets when they become members of GATT and its successor, the World Trade Organization.

TABLE 2

Prices of Potatoes, January 1992 (rubles per kilo)

Vilnius	5.0
Riga	8.0
Moscow	11.0
Tallin	14.0
St. Petersburg	22.0

Source: World Bank. *Lithuania: The Transition to a Market Economy.*

Environment

Under the Soviet system managers were rewarded for fulfilling production quotas without regard for the immediate costs of producers or the broader costs to the environment. Some environmental degradation has occurred in Lithuania, but it has not been as severe as in some parts of the former Soviet Union or eastern-central Europe.[16] There are some air pollution problems in the larger cities (Siauliai, Kaunas, Klaipeda, and Vilnius) and at sites of specific industrial and energy facilities: Elektrenai (oil-fired thermal power plant), Jonava (fertilizer plant), Kedainai (biochemical and fertilizer plants), Mazeikiai (petroleum refinery), and Naujoji Akmene (cement). Water pollution is a problem in the Nemunas River, the Kursiu Lagoon, and the Baltic Sea. Routine closing of recreational beaches at Palanga and Klaipeda have occurred due to pollution of the Baltic and Kirsiu Lagoon by municipal and industrial wastewater.

Agriculture has been the source of some pollution, but price reforms are having a favorable environmental effect. Some very large cattle, hog, and poultry complexes on collective farms created a waste management problem.[17] Application rates for chemical fertilizer have been higher in Lithuania than in neighboring countries, and fertilizer run-off has contributed to pollution of rivers, groundwater, and the Baltic Sea. More than 40 percent of well water in Lithuania is not fit for human consumption.[18] As part of agricultural reform, prices of fertilizer and chemicals have increased relative to agricultural product prices, and application rates for these inputs have already dropped. In addition, reduction in farm size will diminish the waste management problem for livestock operations.

The other potentially serious environmental problem is the Chernobyl-type nuclear power plant at Ignalina in northeastern Lithuania. It does not satisfy Western standards of safety, and residents of neighboring countries would like to have it shut down. Unfortunately Ignalina is currently the source of 60 percent of the country's electrical power, and it would be costly to replace it with an alternative source. Forty percent of electricity generated in recent years has been exported to Latvia, Bela rus, and Kaliningrad. Given the current depressed state of the economy, Lithuania is in a weak position to deal with the Chernobyl issue or more general environmental problems.

> ***"The other potentially serious environmental problem is the Chernobyl-type nuclear power plant."***

Lack of cooperation among the Baltic countries has complicated environmental problems. Lithuanians would like to reduce their dependence on Russian crude oil, and import facilities on the Baltic sea could be used to supply the modern oil refinery at Mazeikiai. Latvia already has an oil importing facility at Ventspils that it is willing to share with Lithuania. However, the Lithuanian government rejected the offer and committed to building its own petroleum terminal at Butinge, within a few kilometers of the Latvian border. This decision may be questionable on both economic and environmental grounds.

Labor, Education, and Migration

Lithuania inherited a perverse reward structure from the Soviet system. Wages and salaries were not related to the supply and demand for particular skills. Workers in certain sectors, such as construction, transport, and industry, were paid more than physicians, scientists, and engineers, even though they lacked a secondary school education.[19] Such a system of rewards will present problems in a market economy. It provides few incentives for people to acquire or retain skills. For people with better job opportunities abroad, it encourages them to emigrate. Lithuanian education is strong in many subjects, but there are also huge gaps, such as in economics and business. Much of the education of the current work force was more suitable for the Soviet system than for a modern market economy. Consequently, retraining is a major task of the educational system.

Labor productivity is reduced by restricting geographical mobility of workers. People are still required to obtain permission from local authorities in order to settle in certain cities.[20] Mobility is also reduced by a chronic shortage of housing and high severance pay imposed on enterprises.

Average wages are extremely low relative to the West, but they are even low relative to Latvia and Estonia.[21] For example, in mid-1992 average Lithuanian wages were $40 per month or $.25 per hour at an exchange rate of 150 rubles per dollar.[22] This reflects extremely low incomes, but low wages present an opportunity for successful production of labor-intensive products. South Korea, Taiwan, Hong Kong, and Singapore have successfully followed this model. The domestic market for products is small, but for successful exporting firms the entire world market is available. Low wages could also attract foreign direct investment if the business climate in Lithuania were judged to be friendly by foreign firms. Lithuania's location on the Baltic Sea could allow it to become a gateway to Russia, Ukraine, and a large Eastern market.

Inflation and Monetary-Fiscal Policy

Following its declaration of independence in March 1990, Lithuania continued to use the ruble as its monetary unit until October 1992. The result was a substantial increase in the inflation rate from 16 percent in 1990 to 225 percent in 1991 to 1,020 percent in 1992 (see Table 1) . This was a substantial shock to a population that had no previous experience with adapting to a high inflation rate. The ruble was replaced by temporary coupons (talonas) in October 1992 and the litas was introduced in June 1993. The inflation rate declined to 189 percent in 1993, and the decline continued in the first half of 1994. The inflation that reached its peak in 1992 reflected rapid growth in the quantity of money created by the central banks of Russia and Lithuania. In Russia, monetary policy was used to finance the government's budget deficit and to extend credit to unprofitable state-owned enterprises. The inflation acted as a kind of tax on all holders of rubles, including residents of independent Lithuania.

Introduction of the Lithuanian litas finally occurred long after Estonia and Latvia had introduced their own national currencies. The delay in abandoning the declining ruble was related to a bitter and protracted dispute between the former head of the Bank of Lithuania (Vilius Baldisis) and the Parliament. After the head of the bank was finally forced to resign in March 1993, he was replaced by Romualdas Visokavicius, who had been the head of a private bank, Litimpex. He was replaced by Kazys Ratkevicious after being accused (and later exonerated) of a conflict of interest involving a loan. The delay in carrying out currency reform introduced unnecessary uncertainty, which probably curtailed development of the very primitive Lithuanian financial sector. As of mid-1994 there were no foreign banks in Lithuania, and delaying monetary reform may have discouraged their entry. Prior to the litas, the de facto unit of account was the U.S. dollar, even though payments were made in rubles or talonas.

The delay in introducing the litas and the rapid turnover in central bankers has reflected a struggle for power among the president, the Parliament, and the central bank. A common and difficult choice for all central bankers is between limiting the quantity of money to avoid inflation and extending loans to government agencies and enterprises that are unable to pay their bills. It is difficult for a central banker to deny a loan request (paid with newly created money) from a finance minister who claims he cannot otherwise pay the salaries of public employees. However, it is well documented that countries whose central banks have little independence from their governments experience higher inflation rates.[23] Central banks in newly independent countries are particularly vulnerable to political pressure to pursue inflationary policies.

To avoid inflation some kind of restraining mechanism or monetary constitution is necessary. In the earlier period of independence restraint was achieved by a fixed exchange rate achieved by linking the litas to gold.[24] In April 1994 a similar restraint was imposed by adopting a currency board that fixed the exchange rate between the litas and the dollar. Estonia had adapted a currency board earlier that fixed the value of the kroon in terms of German marks, and it has achieved the lowest inflation rate among the former Soviet republics.[25] Under a currency board the management has no discretionary authority to extend loans or alter the quantity of domestic money. In the case of Lithuania the currency board is not allowed to extend credit to state enterprises (or anyone else), and the inflation rate is expected to converge to the inflation rate of the United States. The money supply in Lithuania is allowed to change only when there is an excess demand or supply of dollars at the fixed exchange rate of four litai per dollar. Essentially the quantity of litai can increase only if there is a capital inflow or a trade surplus in Lithuania.

The currency board is a new arrangement in Lithuania, and like all new institutions, its durability remains in question. A prominent member of Parliament has already predicted a devaluation of the currency. In addition, interest rates on litas bank accounts and loans are higher than rates on comparable dollar deposits and loans. The difference can be interpreted as the expectation of depreciation of the litas. If the arrangement persists, the main advantages are a lower inflation rate and reduced uncertainty about trade and investment relative to the dollar. However, as long as the inflation rate in Lithuania exceeds the U.S. rate, the profitability of exporting from Lithuania diminishes. A kind of profit squeeze is already showing up for agricultural exporters.[26]

Problems Specific to Lithuania

Many of Lithuania's current economic problems are common to all the fifteen republics of the former Soviet Union as well as the former Communist countries of east-central Europe A complete restructuring of all these economies has been necessary, and the process has been costly. Real income has fallen in all of these countries for three straight years (1990-1992), and only Poland and Hungary experienced growth in 1993.[27] East Germany was in an advantageous position due to its high income relative to Eastern European neighbors and its economic union with prosperous West Germany. However, East Germany's transitional problems have turned out to be much more serious than anticipated, and the severity of its problems have become symbolic of the difficulty of reform in the more serious cases.

In addition to the generic problems facing the former Communist countries, Lithuania faces some special problems. First, Lithuania was one of the republics with the greatest dependence on trade with the other Soviet republics. The value of Lithuania's trade (including trade with other republics) relative to its income was 55 percent compared with 34 percent for Ukraine and 22 percent for Russia.[28] Lithuanian production was directed toward the Soviet market for both manufactured and agricultural products and nearly all production required components made in other republics. Lithuanian production was highly integrated into the USSR industrial network, and a large share of output was for military purposes, especially electronics and telecommunications. Producing goods for Western markets requires a major reorientation by the government, managers, and workers.

The Soviet pricing system also had a profound effect on the Lithuanian economy. Lithuanians were net importers from other republics of energy and feed grain, and prices paid for these important inputs were a small fraction of the comparable world prices. As an exporter of meat and dairy products (especially to the Moscow and Leningrad areas) Lithuania benefitted from artificially cheap imports of feed grain. Subsidized energy imports also influenced a wide range of Lithuanian producers, as well as all consumers. As a consequence, in 1990 Lithuania used 60 percent more energy per capita than would be expected on the basis of income.[29] With the disintegration of the Soviet Union, the loss of these subsidies had as great an adverse effect on Lithuania as it had on any of the republics.[30] Disputes over payment of energy bills resulted in withholding of energy from

Lithuanians by Russian suppliers. A result was a decline in production by industrial energy users and many cold apartments without hot water.

The effect of adjusting relative prices to world levels is evident in agriculture. The previous cheap energy policy encouraged a highly mechanized agriculture in Lithuania. However, when Russia insisted on receiving world prices for its oil and energy products, many Lithuanian producers could no longer afford to buy gasoline for their machinery. Horses have made a comeback on Lithuanian farms, but the saving on imported petroleum has been partly offset by additional feed cost. Higher prices of imported feed grain have contributed to a reduction in the number of animals held on Lithuanian farms in each of the last three years. For half of a century Lithuanian producers had adapted their practices to cheap energy and feed grain, and responding to a vastly different set of conditions has been very difficult.

The location of Lithuania between Kaliningrad and Russia has also presented a problem. While transit rights through Lithuania were being negotiated, the Russian government imposed a discriminatory tariff on Lithuanian products in order to strengthen their bargaining position. The issue had not been resolved by January 1995.

Prospects for the Future

In spite of many serious problems there are some factors conducive to successful economic reform. Foremost is political independence, which allows Lithuanians to choose the kind of economic system that most people want. This choice has not been available since 1940. Second is the historical evidence that prior to the imposition of communism, average incomes of Lithuanians compared favorably with those of their Scandinavian neighbors. Lithuania became the first of the former republics to experience a complete withdrawal of Russian troops (31 August 1993), and ethnic problems are smaller than in the other Baltic states. Workers are relatively well-educated and wages are low. Labor costs should be favorable relative to many Asian, Latin American, and east-central European countries. Its location on the Baltic Sea could place Lithuania in a favorable position to become a trading center between the West and the East. Fifty years of communism is a long time, and the effects will not be erased quickly. However, Lithuania and the Baltic states had a shorter experience with the command economy than the other twelve republics of the former Soviet Union.

> ***"How long will it take to complete the transition from the Soviet system to a market economy?"***

How long will it take to complete the transition from the Soviet system to a market economy? This question is frequently asked in Lithuania, as well as in the West. A precise answer cannot be given, partly because history has given us no previous experience with transforming centrally planned economies into capitalist economies. More fundamentally, the length of the transition period will not be a fixed number of years, determined by inexorable historical forces.[31] Instead it will depend on the kinds of economic policies that Lithuanians choose in the future. Thirty years ago Asia was the poorest region in the world and economic growth was slow. Since then Asia has been the most rapidly growing region in the world. Many examples of prudent economic policies that led to rapid economic growth can be found in Asia today, including Hong Kong, Taiwan, Singapore, and South Korea. Remarkable economic growth has occurred in those sectors of the Chinese economy where market forces have been allowed to prevail. The average rate of economic growth in Latin America has been slower than Asia over the last thirty years, but examples of successful economic reform following periods of comprehensive government control are Chile and Mexico. Conversely, examples of government policies that hinder economic growth include those of nearly every country in Sub-Saharan Africa, where income per capita today is lower than it was thirty years ago. The transition period will be shorter if Lithuanians learn from the experiences of these countries. As of mid-1994 economic reform had not progressed as rapidly in Lithuania as in Estonia and Latvia,[32] and there were fewer joint ventures with foreign firms in Lithuania than in its Baltic neighbors.

Conclusion

The Lithuanian economy is severely depressed, as real income has fallen far below its level at the end of the Soviet period. Many of the current economic problems are directly attributable to the misguided fifty-year economic experiment imposed from Moscow. Governments of Western countries have made the transition period more difficult by pursuing protectionist policies that make it more difficult for Lithuanians to earn foreign exchange necessary to pay for essential imports. However, the policies of the Lithuanian government also bear some responsibility for the current situation.

Economic growth will not occur without a strong commitment to economic reform, and changes that have occurred so far are not sufficient. Essential policy reforms include the establishment and enforcement of full property rights. Comprehensive privatization of state enterprises must be carried out without delay. Government policy should encourage competition in all aspects of the economy, including imports of products and establishment of foreign-owned enterprises that compete with domestic firms. Trade policy should allow exports without imposing export taxes, quotas, or licenses. Tax policy must encourage greater worker productivity and risk-taking by entrepreneurs. Prices must be allowed to respond to the changing conditions of supply and demand. Finally, the Bank of Lithuania must carry out a monetary and exchange rate policy that gives people confidence in the new currency.

Many barriers to economic reform persist. Recipients of food and housing subsidies are understandably reluctant to give them up. Employees and managers of unprofitable state-owned enterprises resist attempts to dismiss redundant workers. The alleged ambivalence of some people toward capitalism may be the most serious barrier to reform.

As of the end of 1994 the results of Lithuanian economic reform have been mixed. Reform has been more successful than in Russia, Ukraine,and most of the former Soviet republics, but less successful than in the other Baltic states, Poland, Hungary, and the Czech Republic.

Notes

1. Romas Tauras Viesulas, "Party Formation in Lithuania *Lituanus* 39 (1993 no. 2): 5-35.

2. John Williamson. *Trade and Payments After Soviet Disintegration*. Policy Analyses in International Economics no. 37 (Washington: Institute for International Economies, 1992), 52.

3. Seija Lainela. "Private Sector Development and Its Prerequisites in the Baltic Countries." Paper presented to the 14th Conference on Baltic Studies, Chicago, 11 June 1994.

4. Brian Van Arkadie and Mats Karlsson. *Economic Survey of the Baltic States*. (New York: New York University Press, 1992). 29. Norman Berdichevsky. "The Baltic Revival and Zionism." *Lituanus* 38 (Spring 1992): 69-78. 76. Antanas Kučas. *Lithuanians in America*. (Boston: Encyclopedia Lituanica, 1975). 24.

5. Brian Van Arkadie and Mats Karlsson. *Economic Survey of the Baltic States*. (New York: New York University Press, 1992). 49.

6. Seija Lainela. "Private Sector Development and Its Prerequisites in the Baltic Countries." Paper presented to the 14th Conference on Baltic Studies, Chicago, 11 June 1994.

7. Brian Van Arkadie and Mats Karlsson. *Economic Survey of the Baltic States*. (New York: New York University Press, 1992). 60-61.

8. Andris Trapans. "Free Economic Zones in the Baltic States: Are They Feasible? Paper presented to the 14th Conference on Baltic Studies. Chicago, 11 June 1994.

9. John Clark. "Law and Disorder in the Baltics: Crime, the State, and the Economic Transition.Paper presented to the 14th Conference on Baltic Studies, Chicago, 11 June 1994.

10. William H. Meyers and Natalija Kazlauskiene. "Agricultural Policy and Structural Reforms in the Baltics: Prospects for Environmental Benefits." Baltic Report no. 93- BR 10, Center for Agricultural and Rural Development. Iowa State University. Ames, Iowa, March 1993. 2.

11. The original intention was that collective farms would differ from state farms by giving managers greater independence from central planners and paying workers a share of earnings rather than a wage. In practice differences were negligible as collective farms were subject to frequent decrees from planners, and collective farms received regular subsidies from the national budget. World Bank 176.

12. Raimundas Dužinskas. "Lithuanian Trade in Agricultural and Food Commodities: Development and State Regulation." in Jaan Kivistik, Materials of the 33rd EAAE Seminar. Tartu, Estonia, May 1992, 81-83, ed. New Trends in East-West Cooperation in Food Production and Marketing." 83.

13. Andrejs Plakans. "Agrarian Reform in the Baltic States Between the World Wars: the Historical Context." in Natalija Kazlauskie ed. *An Overview of Rural Development Strategies for the Baltics*. Baltic Report 93-BR9. Center for Agricultural and Rural Development. Iowa State University. Ames, Iowa, March 1993.

14. World Bank. *Lithuania: The Transition to a Market Economy*. (Washington, D.C.: 1993). 182.

15. Raimundas Dužinskas. "Lithuanian Trade in Agricultural and Food Commodities: Development and State Regulation." in Jaan Kivistik, Materials of the 33rd EAAE Seminar. Tartu, Estonia, May 1992, 81-83, ed. New Trends in East-West Cooperation in Food Production and Marketing." 82.

16. World Bank. *Lithuania: The Transition to a Market Economy*. (Washington, D.C.: 1993). Ch. 19.

17. William H. Meyers and Natalija Kazlauskiene. "Agricultural Policy and Structural Reforms in the Baltics: Prospects for Environmental Benefits." Baltic Report no. 93- BR 10, Center for Agricultural and Rural Development. Iowa State University. Ames, Iowa, March 1993. 3.

18. *Ibid*. 4.

19. World Bank. *Lithuania: The Transition to a Market Economy*. (Washington, D.C.: 1993). 30.

20. *Ibid*. 124.

21. *Baltic Independent*. Tallinn, Estonia. 21 May 1993.

22. The dollar equivalent of Lithuanian wages is sensitive to the exchange rate used to convert rubles, talonas, or litas into dollars. In early 1992 using 100 rubles per dollar average wages were between $10 and $20 per month. World Bank 60, 150.

23. Alex Cukierman, Steven Webb, and Bilin Neyapti. "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes." *World Bank Economic Review* 6. (3): 353-398.

24. The first head of the Bank of Lithuania, Vladas Jurgutis, is sometimes called the father of the litas. See Grennes 1995.

25. Steven J. Hanke, Lars Jonung, and Kurt Schuler *Russian Currency and Finance: A Currency Board Approach to Reform* (London: Routledge, 1993).

26. Natalija Kazlauskiené and William Meyers. "Price and Income Comparisons and Implications for Future Adjustments in the Baltic Countries: An Overview." Paper presented to the 14th Conference on Baltic Studies, Chicago, 11 June 1994.

27. International Monetary Fund. *Survey*. Washington: 9 August 1993. 241.

28. John Williamson. *Trade and Payments After Soviet Disintegration*. Policy Analyses in International Economics no. 37. (Washington: Institute for International Economies, 1992). 52.

29. World Bank. *Lithuania: The Transition to a Market Economy*. (Washington, D.C.: 1993). 158.

30. David Tarr. "How Moving to World Prices Affects the Terms of Trade in 15 Countries of the Former Soviet Union." Working Paper no. WPS 1074 Washington: World Bank, January 1993. 13.

31. Arnold Harberger. "Secrets of Success: A Handful of Heroes." *American Economic Review*, 83 (May 1993) 343-350.

32. Seija Lainela. "Private Sector Development and Its Prerequisites in the Baltic Countries." Paper presented to the 14th Conference on Baltic Studies, Chicago, 11 June 1994.