

Plan of Inflation Control Measures

The Plan of for Inflation Control has been designed bearing the assumptions that inflation is the growth of money supply (in a broad sense) and not of the rise in the general level of prices. To put it otherwise, the growth of the general price level is a consequence of inflation, rather than the cause. Therefore, this Plan excludes measures of price control, because, in our opinion, at best they are likely to have only a temporary effect on price indices and would not resolve the problem of inflation as such.

The main drivers of inflation include: rapidly growing foreign cash inflows, in particular via bank loans; financing of budget deficit via borrowing foreign funds; cash inflows from EU Structural Funds; monetary transfers from emigrants.

We would like to draw attention to the fact that the control of inflation is a long-term and complex goal which is difficult to reach and which requires change in the activities that are beneficial to private and public sectors. Even having implemented all measures proposed in this plan, the effects would be felt only after a few years.

The proposed measures were chosen according to the adequacy of their effects. When assessing the measures we took into consideration whether it is a direct or indirect measure to control inflation, the rate and adequacy of impact, as well as the easiness of its implementation. The easiness of implementation defines actions or changes to be taken or introduced to implement a given measure (e.g., if the implementation of a measure requires only a political or administrative decision, such measure is defined as easily implemented, irrespective of possible related political problems).

| Suggested anti-inflationary measure | Reasoning | Comments | Expected duration of impact of the measure | Strength of impact | Easiness of implementation |
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| <i>Monetary policy</i> | | | | | |
| Retaining the Currency Board | Guarantees stability of the monetary policy, prevents unreasonable currency emissions carried out by the government, because each litas must be backed by a respective amount of foreign currency (euro). | Removal of the currency board would create favourable conditions for the devaluation of currency and growth of prices. Devaluation of Litas would stimulate the growth of import prices to (esp. oil and gas). Due to increased energy costs and reduced competition resulting from more expensive imported goods, local producers would also be able to increase prices. | Removal of the currency board arrangement would cause devaluation of litas against the euro causing immediate growth of consumer prices. | Major | Easy |
| Maintain the existing tight supervision of the activities of banks and other financial institutions | Due to the existence of the lender of last resort and the parent banks, Lithuanian commercial banks are able to apply risk assessments which are too optimistic. Excessive optimism leads to ungrounded expectations and stimulates unreasonable consumption or investment. | More stringent requirements applied on mortgage loans in Latvia had a positive effect. | Measure is already being applied. | Major | Easy |

| <i>Fiscal policy</i> | | | | | |
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| Tighter fiscal policy of the government, balanced budget | <p>Tight fiscal policy would prevent increases in budgetary expenditure (or avoiding unreasonable tax raises to increase revenues). Balanced budget would reduce the need to borrow, slow down the growth rates of money supply and curb inflation.</p> <p>Seeking to achieve budget surplus would enable to reduce the public debt and consequently the costs of its servicing.</p> <p>The Law on State Treasury should provide the possibility for limiting the growth of municipal expenditures in the event of collection of excess revenues, so as to create real preconditions for achieving cyclical balance of the general government budget.</p> <p>Fiscal discipline is frequently understood as tighter control of spending, rather than as growth of revenues. Therefore a more conservative forecast of revenue collection must be accompanied by government plans to reduce or freeze spending.</p> <p>Refrain from semi-annual reviews of</p> | <p>Irrespective of the Law on Fiscal Discipline adopted in 2007, budget deficit of 0.5% GDP is planned for 2008.</p> <p>The upcoming economic slowdown, , means that growth rates of budget revenues will slow down. Due to excessively optimistic planning of the collection of revenues, the budget of the government sector may exceed the Maastricht criterion (3% GDP)¹.</p> <p>This measure would reflect political will and is of particular importance in seeking to shape more positive opinion of foreign experts and investors.</p> <p>Reallocation of the government sector budget in the middle of the year is regulated by the Law on Fiscal Discipline. In 2007 the budget was not reallocated and such practice should be continued in future.</p> | <p>The impact of this measure on the growth of prices is likely to manifest itself in 1–2 years.</p> | Major | Average |

¹ Making an assumption that collection of revenues in years 2008-2009 will be smaller by 10 percent than currently Forecasted, budget deficit of public sector would reach 4.2 percent in 2008 and 3.8 percent in 2009 – it means exceeding Maastricht criteria for two years.

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| | the general government budget. | | | | |
| Avoid creating inflationary expectations among consumers (residents and business); refrain from long-term obligations to increase wages | Long-term obligations create optimistic expectations among individuals and stimulate consumption among consumers on account of the future. | The education, health care and social sectors need structural reforms, which would enable these sectors to maintain themselves at least to a certain extent thereby reducing public expenditures and social pressure. | Impact in 1-2 years | Medium | Easy |
| Eliminate value added tax (VAT) exemptions | <p>Elimination of VAT exemptions would facilitate in the increased collection of budget funds, and consequently to reduce budget deficit.</p> <p>This proposal is based on the concept of uniform business conditions, fair competition and equal opportunities. Larger competition would guarantee lower pressure on prices.</p> | <p>Indirect measure of inflation control.</p> <p>The practice has shown that VAT exemptions do not achieve the established goal of the price reduction. It is forecasted that in 2008 VAT exemption will cost the budget about LTL 350 million (excluding VAT exemption for heating and hot water).</p> | The impact of this measure on the budget would be felt immediately. The impact on price growth decline due to increased competitiveness would manifest itself in a longer term period (1-2 years) | Medium | Easy |
| Eliminate income tax exemptions for purchased goods (computers, dwelling, etc.) | <p>Such tax exemptions stimulate consumption, increase product demand and price (in particular of real estate) and therefore are inconsistent with the established goal.</p> <p>Elimination of tax exemptions would limit demand and ease inflationary</p> | The effects of tax exemption for housing were inconsistent with the social policy as they further stimulated the growth of real estate (RE) demand and prices. Moreover the greatest benefits from this situation were derived by residents who purchased more expensive dwellings. Even with cooling of real-estate market the | The impact of this measure on prices of respective goods would be felt in a few months. | Major | Easy |

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| | pressures, improve collection of budget revenues and contribute to the reduction of budget deficit. | <p>elimination of tax exemptions is a reasonable preventive measure for the future.</p> <p>According to estimates, the cost of tax exemptions for housing in 2006 amounted to about LTL 68 million and was 67.8% larger than a year before. Tax exemptions for computer equipment in 2006 cost LTL 76 million and increased by about 22%.</p> | | | |
| <i>Labour market related measures</i> | | | | | |
| Avoid automatic indexation of wages on the basis of inflation of the previous period | Indexation gives start to the price–income growth spiral. Moreover, it gives rise to the inflationary expectations among residents. | It is a very important measure which, if ignored, would create conditions for unlimited growth of prices and wages leading the economy to the crisis. | Indexation would have an immediate impact on inflation. | Major | Easy |
| Facilitate labour market flexibility and competitiveness | Reduce the regulation of working time and overtime work. Employees and employers must have the possibility to agree between themselves on a more flexible (shorter or longer) business day. Such an agreement would enable part of employees to work longer and earn more, while employers would be able to distribute available workforce more effectively. | According to the World Business Environment Survey (WBES) 2008 of the World Bank, the index of inflexibility of working hours in Lithuania amounts to 80 (0 is used to denote fully flexible working hours and 100 – fully inflexible working hours). | The impact of this measure is likely to manifest itself in 1–2 years. | Medium | Average |
| Increase productivity of labor, in particular in the public sector | Increased productivity of labor would reduce labour market pressure and slow down the growth rate of wages. Slower wages increase would impede the wage-price growth spiral. | Incentives must be created in the public sector for optimisation and creation of added value not only through larger financing, but also utilising all internal resources, introducing innovations, etc. | The impact of this measure can be expected in 2-3 years. | Medium | Difficult |

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| | <p>Higher productivity of public sector would facilitate the creation of larger value added.</p> <p>Labour productivity improvement is also related to structural reforms in education and health care sectors.</p> | <p>It would be recommended to introduce the incentives to reduce the number and shorten the duration of processes in the bureaucratic mechanism, improve the efficiency of its functioning and at the least avoiding the increase of employee numbers.</p> | | | |
| <p>Increase possibilities to foreigners to get temporary employment in Lithuania</p> | <p>Elimination of bureaucratic obstacles for temporary immigration is likely to increase labour supply thereby reducing the tension in labour market and pressure for wage growth.</p> | <p>The existing process of granting work permits is ineffective.</p> | <p>The impact on labour market would be seen in near future, and impact on prices would be observed in 1–2 years.</p> | <p>Medium</p> | <p>Easy</p> |
| <p>Terminate the increases of minimum monthly wage (MMW)</p> <p>Differentiate MMW by age</p> | <p>Sharp increase of MMW causes difficulties for small business sector, in particular in rural areas unreasonably increasing the price of labour.</p> <p>Differentiation of MMW by age would enable young unskilled workers to get employed for smaller MMW.</p> | <p>Smaller and differentiated MMW would facilitate legal employment of people for such jobs in which the value added is smaller than the existing MMW. This would stimulate labour market flexibility, reduce the scope of shadow economy, and hence increase social security for such employees.</p> | <p>The impact of this measure can be expected in 1-2 years.</p> | <p>Medium</p> | <p>Easy</p> |
| <i>Investment and competitiveness related measures</i> | | | | | |
| <p>Promotion of competitiveness and efficiency, in particular in the public sector</p> | <p>This method is a measure of any type of economic activity used to reduce costs and consequently increase the opportunities for offering a service or good of the same quality at a lower price. This would reduce the general government maintenance costs concurrently discontinuing non-value based spending.</p> | <p>This measure is related to the previous statement on the increase of labour productivity in particular in the public sector.</p> <p>The programme of support for small retailers would create preconditions for the increase of competition in trade sector.</p> | <p>The impact of this measure would manifest itself in a longer term period of about 2-4 years.</p> | <p>Major</p> | <p>Difficult</p> |

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| | <p>Promotion of competition in retail trade sector.</p> <p>Elimination of additional holidays would stimulate the competitiveness of business environment.</p> | | | | |
| Promotion of investment and innovation | <p>Avoid taxation of investments designed to increase labour productivity (rather than business expansion). The growth of labour demand will be reduced, and the situation in labour market will improve. More innovative and effective measures would also contribute to ensuring the international competitiveness.</p> <p>The process of development of innovation systems and clusters still lacks the involvement of the government and exists only “on paper”.</p> | <p>Indirect but effective inflation control measure.</p> <p>Shortages of this measure: it is technically difficult to determine the difference between investments in business expansion and investments in productivity.</p> | <p>The impact of this measure would manifest itself in a longer term of 2-4 years.</p> | Major | Difficult |
| <i>Other measures</i> | | | | | |
| <p>Implementation of structural reforms</p> <p>Privatisation and liberalisation of state - administered sectors of the economy</p> | <p>This measure would increase general economic efficiency and facilitate in resolving the main problems of these sectors for which a considerable part of budget funds is currently spent.</p> <p>Allow the establishment of the private market players on equal terms with monopolies to promote competition.</p> | <p>Indirect inflation control measure.</p> <p>The major need for reforms exists in sensitive sectors of education and health care, in which the private initiative should be supported rather than precluded.</p> <p>Competition is the most effective tool against price growth and the main driver of efficiency.</p> | <p>The impact of this measure would manifest itself in a longer term period of 2-4 years.</p> | Major | Difficult |
| Simplify | <p>This measure would be conducive to</p> | <p>Even with market of real estate cooling</p> | <p>The impact of</p> | Major | Average |

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| territorial planning procedures and use of land in general | the reduction of land use restrictions and land price. In its turn this would create possibilities for reduction of construction costs. | down, this measure is effective and useful both, in terms of curbing inflation and overall economic policy. It would be recommended to provide that if municipalities and counties fail to prepare general plans until a certain deadline, the preparation of such plans is initiated by the Government itself. | this measure is likely to manifest itself in 1–2 years. | | |
| Calculation of land tax on land based on the market value | The tax on land based on its real value is a preventive measure protecting from speculations in real-estate market. | | The impact of this measure is likely to manifest itself in 1–2 years. | Major | Average |
| Carry out information analysis of prices | Seek higher transparency making a better use of the existing statistical information; apply benchmarking more frequently announcing changes of prices of particular goods. | Indirect inflation control measure. | Continuous impact. | Small | Easy |
| Promote efficient use of energy | Efficient use of energy would increase the overall economic competitiveness and facilitate in resolving the problems related with high energy prices. The measure is associated with efficiency promotion in business and public sector. | Indirect inflation control measure. VAT exemption, currently applied for heating costs reduces dwelling renovation incentives. Due to compensations for heating and hot water, the renovation of block of flats does not pay off for some residents. It prevents from taking a collective decision to invest in energy saving. | The impact of this measure would manifest itself in a longer term period of 2-4 years. | Medium | Difficult |

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| | | It would be more expedient if expenses for mitigation of the consequences of growing energy prices are allocated for investments in energy saving. | | | |
| Inform and educate the public on important matters of economy and management of individual finance. | <p>This measure would reduce ungrounded optimism and unreasonable borrowing, and would stimulate more sustainable methods of the investment of funds and their protection from depreciation.</p> <p>Proper planning of individual finances and expenses will make the behaviour of people more productive and guarantee for them the reserve for subsistence.</p> | <p>Indirect inflation control measure.</p> <p>Recognition of this problem can stimulate to consider the possibility of the programme of public relations, involving such measures as films, advertising and websites.</p> <p>This measure will generate results, if it is not only of declarative nature, but covers the initiation of public discussions, increase of transparency and publicity as well as the availability of information about the issues of economy not only <i>post factum</i>, but also as early as in the stage of planning..</p> | The impact of this measure would manifest itself in a longer term period of 2-4 years. | Small | Average |