Document of
THE WORLD BANK

FOR OFFICIAL USE ONLY

Report No. 19233

PERFORMANCE AUDIT REPORT

LITHUANIA: REHABILITATION LOAN
(Loan 3524-LT)

April 30, 1999

Operations Evaluation Department

Currency Equivalents

Lithuania - Currency Equivalents (annual averages)
(As of March 1996)

Currency Unit = Lita
US$ 1.00 = 4 Litas
Lita 1 = US$ 0.25

Weights And Measures

Metric System

Fiscal Year

January 1 - December 31

Abbreviations and Acronyms

CIS	Confederation of Independent States
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
ECA	Export Credit Agencies
EDI	Economic Development Institute
EFF	Extended Fund Facility
EFSAP	Enterprise and Financial Sector Assistance Project
EFTA	European Free Trade Area
ESW	Economic and Sector Work
EU	European Union
FIA	Foreign Investment Advisory Service
FSU	Former Soviet Union and Baltic Republics
GAT	General Agreement on Trade and Tariffs
GDP	Gross Domestic Product
GNP	Gross National Product
G-24	Group of 24
IBRD	International Bank for Reconstruction and Development
ICB	International Competitive Bidding
ICR	Implementation Completion Report
IDA	International Development Association
IDF	Institutional Development Fund
IMF	International Monetary Fund
JEXIM	Export Import Bank of Japan
MER	Ministry of Economic Reform
MERP	Memorandum of Economic Reform Policies
MIGA	Multilateral Investment Guarantee Agency
MOF	Ministry of Finance
NIB	Nordic Investment Bank
OECD	Organization for Economic Cooperation & Development
OED	Operations Evaluation Department
PER	Public Expenditure Review
PHARE	Economic Assistance Program for the Restructuring of Poland and Hungary
PIP	Public Investment Program
PIU	Project Implementation Unit
PRL	Power Rehabilitation Loan
PSD	Private Sector Development
SAL	Structural Adjustment Loan
SECAL	Sector Adjustment Loan
SBA	Stand-by Arrangement
SOE	State-owned Enterprise
SSNP	Social Safety Net Project
TA	Technical Assistance
VAT	Value Added Tax

Director General, Operations Evaluation	:	Mr. Robert Picciotto
Director, Operations Evaluation Department	:	Ms. Elizabeth McAllister
Manager	:	Mr. Ruben Lamdany
Task Manager	:	Mr. John H. Johnson
Peer Review	:	Mr. Luis. Ramirez

FOR OFFICIAL USE ONLY

The World Bank
Washington, D.C. 20433
U.S.A.

Office of the Director-General
Operations Evaluation

April 30, 1999

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: Performance Audit Report on Lithuania: Rehabilitation Loan (Ln. 3524-LT)

Attached is the Performance Audit Report (PAR) on the Lithuania–Rehabilitation Loan (Ln. 3524-LT for US$60 million, approved in FY93). The loan closed on December 31, 1995, eighteen months after the original closing date, with about 1.7% of the principal amount being canceled. It was extended in emergency conditions following the break-up of the former Soviet Union.

The Rehabilitation Loan to Lithuania had two main objectives: (i) to assist the Borrower in designing and implementing the stabilization and the structural reform program outlined in its Memorandum of Economic Reform Policies (MERP); and (ii) to help maintain capacity utilization and output in key sectors during the difficult initial phase of transition to a market economy. In preparing these projects, the Bank faced complex trade-offs: How could the Bank finance critically-needed imports, provide timely support for emergent adjustment programs, and ensure accountability for loan resources in a country rebuilding its political and economic institutions.

The loan was approved after Lithuania regained its independence and was coping with disruption of its normal pattern of trade. Flaws in project design, including complex procurement requirements spread over too many sectors, delayed some imports until they were no longer in short supply. On the other hand, the loan provided timely and visible external support for a reform program which has since been deepened and sustained.

On these latter grounds, the PAR rates the project as having a marginally-satisfactory outcome, and being of likely sustainability, thanks to the durable economic recovery which the reform program has made possible. Institutional development achieved is rated as modest, taking into account evidence that international competitive bidding techniques have taken hold in some parts of the public sector, and that the reform program indirectly supported by the loan has achieved profound changes in the economic rules of the game. Borrower performances is rated as marginally satisfactory, largely on account of the Borrower's significant reform achievements during and after loan implementation.

Likewise, Bank performance is rated as marginally satisfactory, taking into account the timely support for a successful transition to a market economy. Nonetheless, the project's flawed design and the overfunding of Lithuania's import needs should be noted.

A key lesson is that procurement for loans designed to finance critical import components needs to be streamlined. One approach would be to pre-identify bulk commodities having standardized specifications. Another approach would be to auction the foreign exchange, subject only to a negative list.

Contents

This report was prepared by John H. Johnson, Task Manager. Eneshi Irene K. Davis and Betty Casely-Hayford provided administrative support.

RATINGS AND RESPONSIBILITIES

	Lithuania *(Loan 3524-LT)*
Outcome	Marginally Satisfactory
Sustainability	Likely
Institutional Development Impact	Modest
Borrower Performance	Marginally Satisfactory
Bank Performance	Marginally Satisfactory

KEY STAFF RESPONSIBLE

		Appraisal	*Completion*
Lithuania	*Task Manager*	Mr. Andrew Ewing	Ms. Barbara Lee
(Ln. 352-LT)	*Division Chief*	Mr.Adil Kanaan	Mr. James Q. Harrison
	Programs/Country Director	Mr.Russell Cheetham	Mr. Basil G. Kavalsky

The ICR was prepared as follows:		
Lithuania: Rehabilitation Loan	Ln. 3524-LT	Ms. Barbara Lee

PREFACE

1. This is the Performance Audit Report (PAR) on the Lithuania Rehabilitation Loan (Ln. 3524-LT), approved in October 1992. The loan was extended to assist Lithuania in dealing with critical foreign exchange and import shortages following the break-up of the former Soviet Union, particularly in the natural gas, agricultural, and health service sectors. The loan was later amended—largely because hard currency ceased to be in short supply—to reallocate the funds for enterprise imports of essential goods. A companion Rehabilitation Loan, in the amount of US$45 million, was extended in June 1993 by the Export-Import Bank of Japan (JEXIM), and administered by the Bank.

2. The PAR focuses on the difficulty of designing a rehabilitation loan so that it disburses quickly during the period of greatest shortages, while simultaneously maintaining accountability for the efficient use of the funds. The PAR concludes that the loan was most successful in providing timely and visible Bank support for an adjustment effort which, albeit with delays, has ultimately been sustained; it was least successful in the timely financing of critical imports. The PAR contends that funds uncommitted by Fall 1993 should have been cancelled because the critical import shortages had by then ceased, thanks to inflows of large-scale financial assistance.

3. The draft PAR was sent to relevant officials in the Government for comments. However, no comments were received.

1. INTRODUCTION

1.1 The Rehabilitation Loan was prepared under intense time pressures. The Bank faced an unappealing trade-off. On the one hand, the Bank was eager to provide timely public support for promising adjustment measures and urgently-needed foreign exchange for imports. On the other hand, the Bank sought to maintain adequate controls over the use of the funds in a country where political and economic institutions were only beginning to function.

1.2 As this audit will demonstrate, the loan was most successful in providing tangible Bank support for Lithuania's adjustment efforts. But, as a device for helping finance urgent import needs, particularly during the critical winter, spring, and summer of 1992-93, the loan fell short of expectations.

1.3 Rather than canceling the remainder of the Loan, the Bank and Borrower sought to identify new import needs, leading to new delays. The revised list of imports, adopted during the last 19 months of implementation, responded increasingly to the vested interests of various state agencies, searching for ways to convert what was intended to be short-term commercial sub-loans into a source of long-term investment and working-capital. Since these latter uses were not contemplated under the original loan design, no appraisal or supervision capacity for such long-term credits had been established. The approval of the JEXIM loan in June 1993 only exacerbated the problem of finding productive uses for the uncommitted resources.

1.4 There were four key reasons for this outcome. First, there were severe organizational deficiencies. Turnover in the high-level Steering Committee and in the Project Implementation Unit (PIU) made it difficult for the project to obtain a strong bureaucratic footing during the first two years of implementation. Moreover, the rapidly-changing status of the state purchasing agencies added further confusion, as state enterprises were privatized or went bankrupt and dropped out of the procurement process. The Government of Lithuania's lack of experience with international competitive bidding made it imperative that the project provide strong technical assistance.

1.5 Secondly, the structural changes beginning to occur in the economy as a result of the transition to the market brought rapid, and often confusing, changes in the pattern of import demand. Requested imports rapidly changed, after the first year, from standardized commodities in relatively large lots, to non-homogenous spare parts and equipment in relatively small lots, increasing the complexity of procurement and overburdening the PIU. And rapidly growing export earnings during 1993-94 increased the availability of foreign exchange and reduced demand for project finance. Thirdly, the Bank's procurement controls, designed to promote transparency and accountability, were complex and burdensome for the Borrower to master, and largely at odds with the short-term character of the loan. Fourthly, the loan design failed to anticipate that importers, both public and private, lacked at the outset sufficient local currency to acquire critically-needed imports. The effort to establish on-lending mechanisms during implementation contributed to further delays and, in some cases, encouraged unsound lending practices and moral hazard for the banks involved.

2. BACKGROUND

Lithuania Rehabilitation Loan (l3524-lt)

2.1 The Lithuania Rehabilitation Loan (L3524-LT), in the amount of US$60 million, financed principally imported inputs of natural gas, pharmaceutical products, and agricultural chemicals. The loan's resources were complemented by parallel financing of US$45 million from JEXIM. The loan was supported by grant technical assistance from the Government of Sweden, targeted at overcoming the implementation difficulties expected while the Borrower learned Bank procurement procedures.

Table 2.1: Imports Financed by Rehabilitation Loan to Lithuania, 1993-95 (US$ millions)

Category	*1993*	*1994*	*1995*
Health	0.8	4.7	3.4
Energy - (Natural Gas)	20.1	-	8.9
Transport	-	0.3	0.9
Agriculture	16.5	2.4	-
Public Administration	-	-	0.6
Total Imports Financed under Rehabilitation Loan	37.3	7.3	13.7
Total Imports	**2044.5**	**2210.0**	**2899.8**
Imports Financed under Rehabilitation Loan as % of Total Imports	1.8%	0.3%	0.5%
Total Imports of Food & Agricultural Products	**157.0**	**212.0**	**439.0**
Imports of Food & Agricultural Products Financed under Rehabilitation Loan (% of Total Imports of Food & Agricultural Products)	10.5%	1.1%	-
Total Imports of Natural Gas[1]	**163.0**[2]	**150.0**	**137.0**[2]
Imports of Natural Gas Financed under Rehabilitation Loan as % of Total Imports of Natural Gas.	12.3%	-	6.5%

Sources: Implementation Completion Report, Lithuania Rehabilitation Loan; Lithuania Country Teams, World Bank and IMF; and World Bank Economic and Social Database.

[1] SITC - CTCI Code 341.

[2] Estimated.

2.2 Table 2.1 provides a breakdown of the imports financed under the loan. Overall, the Rehabilitation Loan financed a small and diminishing share of total Lithuanian imports, starting at 1.8 % in 1993, and declining to 0.5 percent in 1995. Imports of food, agricultural chemicals, and natural gas together exceeded 10 percent of Lithuania's 1993 requirements in these sectors, the period of greatest shortages. But overall, Rehabilitation Loan resources financed an insignificant share of Lithuania's total imports, even in the emergency year (1993).

3. THE ECONOMIC SCENARIO IN LITHUANIA AT THE TIME OF THE LOAN PREPARATION[1]

3.1 Lithuania began its reforms on a modest scale less than one year prior to obtaining its political independence from the Former Soviet Union (FSU) in 1991. The remnants of fifty years of central planning and integration with the FSU left the economy largely unprepared to function effectively as a market economy. Rapid industrialization during the pre-independence phase had created significant capacity in machine-building, metal-working, textile, leather and wood-processing, and agro-processing, most of which had been exported to the FSU. Much of this capacity was economically uncompetitive in Western markets, while simultaneously cut off from traditional markets to the East. Dire shortages of basic consumption commodities and key raw materials soon followed.

4. DESIGN OF THE LOAN

4.1 The Lithuania Rehabilitation Loan had dual objectives, and it is critical to assess the importance to be ascribed to each of these objectives. First, it aimed at providing emergency assistance at a critical juncture of a vast, anticipated transformation from a command to a market economy. The concerns were avoiding a total collapse in production before this transformation could be completed, while providing consumers with an uninterrupted flow of the most basic public services.

4.2 Financing was directed to the purchase of imported commodities, such as natural gas, pharmaceuticals, and agricultural chemicals. The Bank and the Borrower hoped that disbursement could be concluded in nine-to-twelve months, covering the harsh winter period and spring planting. Anticipating that new import channels were likely to arise during this period, the Bank proposed provisions allowing for private-sector imports to be financed, but this option was rejected by the Government, which insisted only state purchasing agencies be eligible. In mid-1992, when this loan was being prepared and appraised, state purchasing agencies and enterprises were the only institutions with any experience in contracting and importing. While they were the only agencies available, these state-run enterprises were also the least suitable channel for importing efficiently into an economy that was undergoing rapid privatization of the retail and commercial sectors.

[1] See, also, the Implementation Completion Report: **Lithuania Rehabilitation Loan** (Report No. 15650, dated May 24, 1996).

4.3 Secondly, the loan supported the design and implementation of a stabilization and structural reform program which had been only partially elaborated in public documents prior to loan approval. There was little disposition or capacity to implement significant reforms, given the burdens of nation-building in the wake of political independence. Lithuania had received wide-ranging offers of assistance from multilateral and bilateral donors, far in excess of its absorptive capacity, so this expectation may also have blunted the sense of urgency in Lithuania about pushing ahead with major reforms. Moreover, the Bank needed more time to familiarize itself with the new Borrower, identify key reform needs, and work out with the Borrower a set of appropriate remedies. A SAL or a SECAL would have been taken several years to prepare and implement, and, given the urgency of the situation, was impractical as an option.

4.4 So, the Bank opted for a quick-disbursing program loan loosely tied to the implementation of the still emerging reform agenda, but with no specific conditionality. The Government of Lithuania (GOL) pledged to: (a) implement the policy measures outlined in a Letter of Development Policy submitted prior to approval; (b) establish and maintain an adequately-staffed PIU; and (c) procure critically-needed imports under standard Bank procurement procedures.

4.5 The adjustment measures identified in the Letter of Development Policy included: (a) deepening trade liberalization through reductions in maximum tariffs, the elimination of all quantitative import restrictions and export tariffs, the maintenance of flexible exchange rate policies, and the introduction of a revised export incentive scheme; (b) strengthening public sector performance through increased government saving, improved tax administration, a shift from taxation of external trade to taxation of domestic income and consumption, increased public utility tariffs, review of the 1992-93 public investment program for its relevance to emerging market forces, and steps to strengthen public enterprise management; (c) lowering or restricting the coverage of guaranteed crop prices, agricultural import quotas, and food and production subsidies; (d) easing interest rate controls, consolidating public sector lines of credit, redefining the role of state agricultural banks, and strengthening bank supervision; and (e) targeting public assistance to the poor.

5. IMPLEMENTATION OF THE LOANS

Critical Import Components

5.1 During implementation, it became apparent that the Rehabilitation Loan suffered from a number of design flaws, which blunted achievement of the emergency import objective. The most critical period for receiving these imports was during the first twelve months after approval, i.e., from October 1992 until September 1993. The Bank established a target of one year for full disbursement of the loan. In fact, the loan required two-and-a-half times that long to disburse. Until October 1993, disbursement proceeded slowly, hampered by the lack of experience of the PIU and government purchasing agents, a significant delay in obtaining the procurement technical assistance, changes in the pattern of import demand, and the incompatibility of complex Bank procurement procedures with the short-term character of the loan. At closing, 6 percent of the loan was canceled.

5.2 Only about one-third of all imports financed under the Loan were actually delivered during the periods they were most needed, i.e., for agriculture and pharmaceuticals between October 1992 and June 1993, for lubricants before the 1993 heating season, and for natural gas between October 1992 and March 1995. What did get in filled urgent needs, mainly for natural gas and diesel fuel. But, in general, officials of the PIU, purchasing agencies, and private entities complained of long delays and sometimes shoddy goods, such as pharmaceuticals which, notwithstanding the Bank's elaborate bidding procedures, arrived late, wet, and in damaged containers, and lubricants which arrived late and overpriced. Imported second-hand buses and medical and dental equipment for use by private practitioners encountered delays of two years or more to complete.

5.3 A number of factors slowed disbursement. First, the list of critical imports, originally quite simple, became increasingly convoluted as demand shifted, necessitating frequent Bank missions, an extensive exchange of correspondence, and constant tinkering with the list of eligible imports. The Deputy Coordinator of the PIU noted: "One conclusion is fairly obvious at this stage: if the loan had been used exclusively in accordance with its original objectives, for procurement of commodities (diesel fuel and natural gas) and other standard products like pharmaceuticals and spare parts, the Project would have been accomplished within its original timeframe (mid-1994). Due to the requests from the beneficiaries concerned, supported by the State Loan Commission (a body created in late 1993), the Bank departed from its traditional approach. It agreed to finance the procurement of used buses and medical and dental equipment for use in the private sector. These procurement actions proved to be quite complicated and time-consuming. As we know now, implementation was extended considerably."[2]

5.4 Secondly, the PIU and purchasing agencies were inexperienced in conducting international procurement. A number of events exacerbated this problem. The PIU's first director, having just completed specialized training in procurement, resigned to accept a job in the private sector in September 1992, just as the Loan was about to go to the Board. The external procurement advisor through Swedish grant assistance was available only on a half-time basis during the critical start-up period. Turnover in the PIU was high, as officials continued exiting for better-paying private-sector positions. And the PIU and purchasing agencies were hampered for the first year-and-a-half by shortages of computers and other modern office technology, and of staff fluent in languages widely used in international commerce.

5.5 Thirdly, following the first year of implementation, the Government appointed a high-level Steering Committee, which proceeded to reshuffle and expand the list of priority categories of eligible imports, leading to lengthy new negotiations with the Bank and further delays. Preparation and appraisal had not led to mutual understanding about what the concept of "rehabilitation" did and did not include, so the Borrower felt it was within its right to demand that the Loan be extended to cover investment goods. The misunderstanding led to friction among the purchasing agencies, the PIU, and the Bank.

5.6 Fourthly, many end-users lacked the financial means to pay for the imports. Indeed, it was the local currency shortages, rather than foreign exchange, which provided one of the largest bottlenecks to procurement. To cope with this unanticipated problem, the Borrower approved an on-lending facility during implementation, the creation of which added to project delays. -

---

2 Statement of February 21, 1996.

Extending multi-year repayment terms at subsidized interest rates to finance short-term purchases, the on-lending facility provided in effect long-term investment loans for up to seventeen years, for which no appraisal or supervision capacity had been established. The state purchasing agencies, inviable and uncompetitive, strove mightily from late-1993 onward, to convert short-term procurement sub-loans into medium- to long-term working capital finance, and to pressure the Bank into allowing more imports of spare parts and equipment as part of large-scale modernization projects. For the banks involved, this facility encouraged unsound lending practices and, in some cases, created moral hazard.[3]

5.7 Fifthly, after 1993, a new problem began to emerge. New privately-run import channels sprang up, and the volume of external aid proved largely in excess of Lithuania's emergency import requirements.

Economic Reforms

5.8 Lithuania's progress toward reorienting its economy from a centrally-planned to a market system has been substantial, but uneven. Reforms began in 1990/91 in an environment of severe contraction and deteriorating terms of trade, imposing severe hardships on the population. Progress toward stabilization was more rapid and comprehensive on the whole than the implementation of structural reforms. But, by any reasonable standard, the stabilization and reform measures, supported by follow-on operations financed by the Bank and other donors, had, by 1998, far surpassed the reforms promised in the 1992 MERP.

5.9 Lithuania's national currency, the *litas*, was introduced in June 1993, and a currency board established in April 1994. Monetary policy has been restrictive for the most part; fiscal policy less so (Table 5.1). As external financing of imports became available, the current account (excluding official transfers) shifted from a surplus of about US$60 million in 1992, to a deficit of about US$150 million in 1995. A continuous shift toward trade with the West has also occurred. By the end of the period of loan implementation, the economy was showing signs of increased health. Average annual inflation, which skyrocketed to about 1,020 percent in 1992, had fallen to about 30 percent by 1996, while the economy resumed sustained, but modest, growth after 1993.

5.10 Structural reforms proceeded rapidly in some areas, such as the relaxation of price controls, privatization of housing and small enterprises, and trade liberalization, and slowly in others, such as privatizing the large state enterprises and reducing the resort to directed credit from state-owned banks. A new trade regime adopted in July 1993 reduced most non-agricultural import tariffs below 10 percent, and eliminated virtually all non-tariff barriers. Export licensing, quotas, and bans were also abolished, except for timber and raw hides. Restrictions on private ownership of land by were abolished for citizens and liberalized for foreigners within the framework of the MERP-specified commitments. And, by 1997, over two-thirds of the large state enterprises had been privatized with vouchers, and additional state assets privatized outside the voucher program. Pricing and trade regime liberalization early in the transition process facilitated the rise of nearly all non-agricultural prices to world market levels.

3 These points were made by the Bank's then Resident Representative to the Baltic States in a memorandum dated June 8, 1998.

5.11 The privatization program, initiated soon after independence, achieved some success. Housing privatization is virtually complete. Nearly all small businesses, and some 60 percent of industrial enterprises, have been privatized through a voucher program. Almost 40 percent of arable land is now privately cultivated. Private sector activity now absorbs a dominant share of the workforce.

5.12 On the other hand, restructuring of the financial sector progressed more slowly. Insolvency among major state-owned banks forced adoption of a broad restructuring plan in 1996, with support from the international community, involving recapitalization and privatization, an enhanced regulatory framework , and strengthened enforcement of bank supervision.

5.13 Poverty increased significantly, particularly in rural areas, in a country which had enjoyed one of the highest standards of living in the FSU. A new pension law passed in 1994 provides retirees with income above the poverty cut-off level, while discouraging early retirement and abuse of disability provisions. Unemployment insurance was also restructured to cope more effectively with the rise in open unemployment.

Table 5.1: Lithuania: Key Macroeconomic Indicators, 1992-97

	Real GDP Output % Growth	*Inflation Consumer Prices (annual %)*	*Fiscal Balance (% GDP)*
Year			
1992	-37.0	1020	0.8
1993	-24.2	410	-3.1
1994	1.0	69	-4.2
1995	3.1	32	-3.3
1996	3.6	25	-3.6
1997			

	Current Account Balance (% GDP)	*Gross Domestic Savings (% GDP)*	*Total Debt Service (% Exports GFS)*
Year			
		..	..
1992	2.9	26.6	..
1993	-6.5	14.5	
1994	-4.2	9.4	2.7
1995	-3.2	14.3	2.5
1996	-3.1	14.4	2.8
1997 [1]			

Source: World Development Indicators (WDI); ECA Regional Data

6. OUTCOME AND SUSTAINABILITY

Outcome

6.1 The outcome of the Rehabilitation Loan is adjudged to be **marginally satisfactory**. While achievement of the emergency critical imports objective was partial and inefficient, the Loan played a useful part in mobilizing broader external financial support for what has turned out to be a substantial, and sustainable program of stabilization and adjustment, which has led to steady economic recovery in Lithuania and significant progress toward establishing a market-oriented economy.

Sustainability

6.2 The sustainability of the Loan is judged as **likely**. This judgment is based largely upon the ongoing success of the Borrower's adjustment efforts, which are considered the principal benefit of these loans. The mixed results from the critical-import component weigh less heavily in judging sustainability, since, by intention, these were designed to have only a short-term impact.

7. BANK PERFORMANCE

7.1 The Bank deserves praise for having moved with alacrity to support Lithuania's reforms at a time when the political and economic systems were under severe stress. On this basis, notwithstanding the serious shortcomings noted below, Bank performance is rated **marginally satisfactory**.

7.2 Roughly two-thirds of the imports financed under the loan were delivered after the emergency was over. The Bank also failed to respond appropriately when structural changes sharply reduced Lithuania's need for emergency imports. Rather than urging the Borrower to cancel the project, and the accompanying JEXIM co-financing in late-1993, the Bank allowed itself to become engaged with the Borrower on a complicated and wide-ranging set of negotiations about imports which had never been contemplated under the original loan design. Important beneficiaries of the liberalized import provisions turned out to be state enterprises struggling to survive. Since no appraisal capacity of these new uses had been built into the Loan, it is likely that much of these proceeds were squandered in sub-projects having low economic rates of returns.

7.3 Quality at entry of the Rehabilitation Loan was **unsatisfactory**. Project design was rigid and partly inappropriate, with procurement methods clearly too cumbersome to be implemented swiftly and far too complex for a Borrower totally new to the Bank's way of doing things. The delays largely defeated achievement of one of the two main project objectives: rapid procurement to alleviate shortages. Moreover, the selection of the external procurement advisor should have been on a full-time basis from the outset of implementation and greater efforts made to equip the PIU and the purchasing agencies from early days with acceptable office technology. Overall, loan documents and discussions with Lithuanian auditors indicated that there was some misprocurement under the loan, notably of certain fuel oil and agricultural seed shipments.

However, in this case, procurement controls and strong supervision limited the incidence of misprocurement relative to some other G-24 aid initiatives during this period.

7.4 There were other shortcomings in loan appraisal. The Bank overestimated Lithuania's foreign exchange needs, creating a loan that was too large by half. The problem was exacerbated by the addition of JEXIM co-financing in the amount of US$45 million equivalent, which increased the envelope of financing for rehabilitation resources by two-thirds. Another problem was that end-users, like municipalities, hospitals, and farmers, often lacked liquidity, and required either credit financing or budgetary support. An on-lending facility created by the Government after the loan had been approved provided long-term credit at subsidized interest rates for what were essentially short-term transactions.

7.5 There were also misunderstandings between the Bank and the Borrower about what "rehabilitation" implied about the kinds of imports eligible for financing. This point should have been clarified during appraisal and negotiations. During implementation, the Borrower insisted "rehabilitation" included sub-projects to refurbish and modernize enterprises, whereas the Bank had always meant this term to allow importation only of commodities and basic materials in critically-short supply. The Bank later relaxed these restrictions, but only after considerable friction with certain ministries, the PIU, and related state enterprises was generated. Having made concessions, the Bank was then placed in the uncomfortable position of approving applications for imports of spare parts and machinery related to modernization sub-projects, when no appraisal mechanism had been established to assess their economic justification.

7.6 With some reservations, supervision is rated **satisfactory**. Major commitments of high quality staff resources struggled under the burdensome requirements of Bank procurement and the Borrower's unfamiliarity with the Bank. Extensive training the Bank provided on international procurement provided modest long-term benefits, although it came too late to facilitate implementation of this project. However, after the first year of implementation, the Bank was remiss in not recommending cancellation of the undisbursed balance (roughly one-half of the Loan), along with the entire JEXIM loan.

8. BORROWER PERFORMANCE

8.1 For the Borrower, preparation and implementation of the Rehabilitation loans posed undeniable difficulties, including the challenges of nation-building, coping with acute macroeconomic imbalances, and coordinating large amounts of new foreign aid initiatives from a dozen external donors. Preparation of the first wave of aid projects had to be compressed into a short time period, when the public sector was experiencing heavy losses of experienced staff to the private sector. In retrospect, the Borrower was slow in staffing and equipping the PIU and should have requested cancellation of unneeded loan balances at the end of 1993, rather than searching for new outlets in modernization projects of questionable economic viability. The on-lending financing terms were long-term and subsidized, encouraging rent-seeking behavior on the part of state purchasing agencies and enterprises. On the other hand, progress toward the stabilization and structural reforms the Rehabilitation Loan was intended to support was significant. On balance, Borrower performance is rated as **marginally satisfactory**.

Institutional Development

8.2 The Rehabilitation Loan indirectly and modestly supported a gradual change in the economic rules of the game in Lithuania. A command economy has been replaced over the past six years with a market-based system (at least outside of agriculture). Some of the benefits from improving international procurement procedures were dissipated by the high turnover of staff in public agencies, but, ironically, this may have sped the adoption of improved procurement procedures in the private sector. However, since the Rehabilitation Loan focussed principally on procurement and played only a minor role in supporting wider institutional reforms, institutional development is rated as **modest**.

9. LESSONS LEARNED

9.1 There are several lessons which emerge from Lithuania's experience:

(a) The design of the Rehabilitation Loan was flawed in that it sought to achieve laudable, but contradictory, objectives, i.e., (a) mobilizing donor funds to support ambitious reforms; (b) providing emergency financing for imports urgently needed to restart production; and (c) maintaining detailed control over the allocation and disbursement of the funds.

(b) A better project design would have been to auction off the foreign exchange from the Loan exclusively to private-sector bidders, supported by a short-term on-lending facility to deal with the illiquidity of end-users. This would have encouraged the emergence of a market-based solution to the question of which imports were most urgently required. However, it might have introduced a new problem, namely the appearance of public sector management of the outcome of the auction, through the mechanism of qualifying bidders for domestic financing. Notwithstanding, this approach would likely have been more effective than the one the Bank actually chose, with a greater potential for avoiding some of the bottlenecks the Rehabilitation Loan encountered.

(c) Reliance upon state enterprises and purchasing agencies, many of them in dire financial and institutional straits, to act as lead importers proved to be a flawed choice, however much the decision was dictated by the shortage of competent private sector importers at appraisal. State importers were sometimes more interested in altering the composition of the sub-loans to meet their own modernization needs, rather than those of the public, particularly after 1993;

(d) The Bank should have encouraged the Borrower to cancel some portion of the Loan, once it became apparent the import emergency had passed, along with the undisbursed balances of the JEXIM cofinancing;

(e) Intensive efforts to pre-identify critical import needs, even when supported by ample technical assistance, are usually inadequate to equip a new borrower with the means to administer standard Bank-mandated procurement regulations. In these circumstances, the Bank would be well-advised to simplify its procurement requirements; postpone rehabilitation lending until the Borrower's procurement institutions have achieved a minimally-acceptable level of function; and/or use only a negative import list;

(f) Project Implementation Units suffer high turnover when pay and incentives are inadequate to prevent skilled managers from defecting to an emerging private sector;

(g) The Bank needs to monitor closely the performance of external procurement advisors, particularly during the first year of implementation, and encourage decisive action when arrangements prove to be unsatisfactory; and

(h) Good Borrower performance in meeting a key operational objective (stabilization and adjustment) can sometimes produce a satisfactory outcome, even when a loan suffers from serious design and implementation flaws.

ANNEXES

Basic Data Sheet

LITHUANIA - REHABILITATION LOAN (LOAN 3524-LT)

Key Project Data *(Amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	105.25	104.25	99.0
Loan amount	60.00	58.78	98.0
Cancellation	-	1.22	-
Date physical components completed	06/30/94	12/31/95	-

Cumulative Estimated and Actual Disbursements

	FY93	*FY94*	*FY95*	*FY96*
Appraisal estimate (US$M)	35	60	60	60
Actual (US$M)	6.9	45.87	57.24	59.0
Actual as % of appraisal	20%	76%	95%	95%
Date of final disbursement: February 7, 1996				

Project Dates

	Original	*Actual*
Negotiations	07/92	08/31/92
Letters of Development Policy	08/92	09/92
Board approval	09/29/92	10/22/92
Signing	-	10/23/92
Effectiveness	10/92	11/05/92
Closing date	06/30/94	12/31/95

Staff Inputs (*Staff Weeks*)

	Planned		*Actual*	
	Weeks	*US$*	*Weeks*	*US$*
Preappraisal	NA	NA	NA	NA
Appraisal	NA	NA	33.7	87.6
Negotiations	NA	NA	11.3	29.6
Supervision	43	108.6	72.9	189.6
Completion	17	44	2.3	9.5

NA = data not available

Mission Data

					Performance Rating[2]		
	Date Month/Year	*No. of Persons*	*Days in Field*	*Specialization*[1]	*Implementation Status*	*Development Objectives*	*Types of Problems*[3]
Through Appraisal	03/93	10	12	E, O			
Appraisal	06/92	7	14	E, O			
Supervision I	01/93	2	9	O	1	1	-
Supervison II	06/93	5	11	E, O	2	2	M
Supervision III	10/93	2		E, O	2	2	M
Supervision IV	04/94	1	5	E, O	2	2	M
Supervision V	06/94	1		E, O	2	2	M
Supervision VI	06/95	2		E, O			
Completion	02/96	3	10	E, O	1	1	-

[1]Specialization	[2]Performance Rating	[3]Types of Problems
E = Economist	1 = Minor problems	F = Financial
O = Other*	2 = Moderate problems	M = Managerial
	3 = Major problems	T = Technical

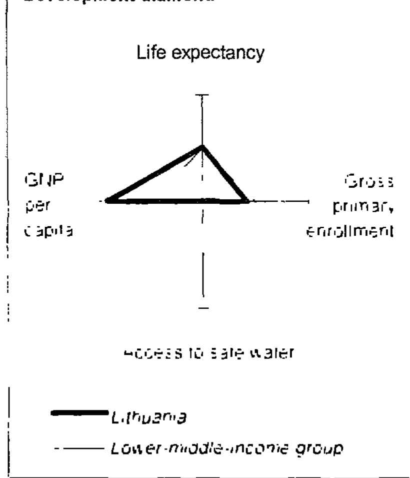
*Other includes country officer, operations analyst, sector specialist, procurement and disbursement specialists. Many of the specialists visited the country in combination with other missions.

Lithuania at a glance

9/30/98

POVERTY and SOCIAL	Lithuania	Europe & Central Asia	Lower-middle-income
1997			
Population, mid-year *(millions)*	3.7	476	2,285
GNP per capita *(Atlas method, US$)*	2,230	2,320	1,230
GNP *(Atlas method, US$ billions)*	8.3	1,106	2,818
Average annual growth, 1991-97			
Population *(%)*	-0.2	0.2	1.2
Labor force *(%)*	-0.2	0.5	1.[illegible]
Most recent estimate (latest year available, 1991-97)			
Poverty *(% of population below national poverty line)*			
Urban population *(% of total population)*	73	67	42
Life expectancy at birth *(years)*	71	69	69
Infant mortality *(per 1,000 live births)*	10	25	36
Child malnutrition *(% of children under 5)*			
Access to safe water *(% of population)*			64
Illiteracy *(% of population age 15+)*			19
Gross primary enrollment *(% of school-age population)*	94	92	111
Male			116
Female			113

Development diamond*

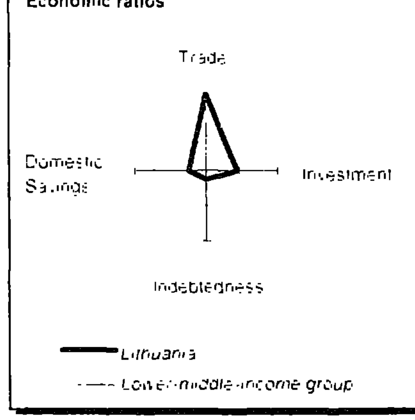


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1976	1986	1996	1997
GDP *(US$ billions)*			7.9	9.6
Gross domestic investment/GDP			24.5	23.5
Exports of goods and services/GDP			53.4	54.0
Gross domestic savings/GDP			14.7	13.3
Gross national savings/GDP			15.0	13.[illegible]
Current account balance/GDP			9.0	-10.3
Interest payments/GDP			0.7	0.9
Total debt/GDP			15.5	16.1
Total debt service/exports			2.9	4.3
Present value of debt/GDP			14.8	
Present value of debt/exports			27.3	

	1976-86	1987-97	1996	1997	1998-02
(average annual growth)					
GDP		-4.9	4.7	5.7	5.2
GNP per capita		-4.0	2.7	2.9	5.0
Exports of goods and services			3.6	6.5	7.5

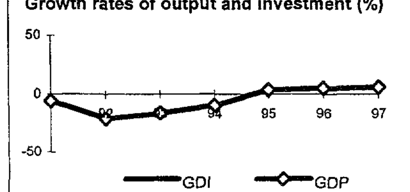
Economic ratios*



STRUCTURE of the ECONOMY

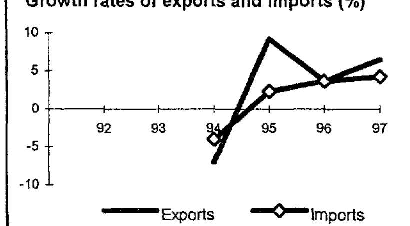
	1976	1986	1996	1997
(% of GDP)				
Agriculture	..	..	12.4	12.8
Industry	..	..	33.4	31.8
Manufacturing	..	..	22.2	20.6
Services	..	..	54.2	55.4
Private consumption	..	..	66.4	67.1
General government consumption	..	..	18.9	19.6
Imports of goods and services	..	..	63.2	64.8

Growth rates of output and investment (%)



	1976-86	1987-97	1996	1997
(average annual growth)				
Agriculture	..	-2.8	12.1	5.9
Industry	..	-12.6	3.7	4.7
Manufacturing	..	..	..	..
Services	..	-0.7	2.3	5.8
Private consumption	..	..	8.5	..
General government consumption	..	..	-3.7	..
Gross domestic investment	..	..	..	..
Imports of goods and services	..	..	3.6	4.2
Gross national product	..	-4.0	2.6	2.7

Growth rates of exports and imports (%)



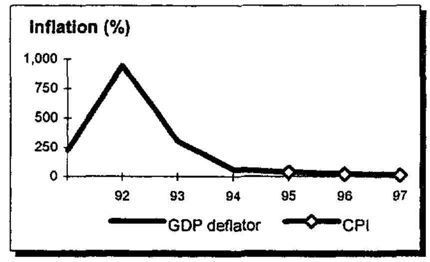
Note: 1997 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Lithuania

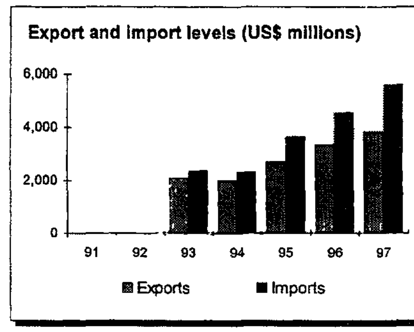
PRICES and GOVERNMENT FINANCE

	1976	1986	1996	1997
Domestic prices				
(% change)				
Consumer prices	..	..	24.6	8.9
Implicit GDP deflator	..	..	25.0	14.5
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	..	21.3	21.6
Current budget balance	..	..	0.1	0.4
Overall surplus/deficit	..	..	-2.5	-1.0



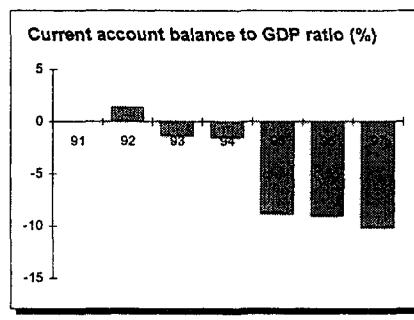
TRADE

	1976	1986	1996	1997
(US$ millions)				
Total exports (fob)	..	..	3,356	3,863
Mineral fuels and distillates	..	..	499	682
Textiles	..	..	524	623
Machinery and electrical	..	..	396	468
Total imports (cif)	..	..	4,559	5,644
Machinery and electrical	..	..	719	1,037
Mineral products	..	..	519	1,026
Chemicals and allied products	..	..	430	529
Export price index *(1995=100)*	..	..	127	148
Import price index *(1995=100)*	..	..	123	147
Terms of trade *(1995=100)*	..	..	103	101



BALANCE of PAYMENTS

	1976	1986	1996	1997
(US$ millions)				
Exports of goods and services	..	..	4,211	5,224
Imports of goods and services	..	..	4,986	6,237
Resource balance	..	..	-775	-1,013
Net income	..	..	-91	-198
Net current transfers	..	..	144	230
Current account balance	..	..	-723	-981
Financing items (net)	..	..	738	1,219
Changes in net reserves	..	..	-15	-238
Memo:				
Reserves including gold *(US$ millions)*	..	..	834	1,063
Conversion rate *(DEC, local/US$)*	..	..	4.0	4.0



EXTERNAL DEBT and RESOURCE FLOWS

	1976	1986	1996	1997
(US$ millions)				
Total debt outstanding and disbursed	..	..	1,226	1,540
IBRD	..	..	101	120
IDA	..	..	0	0
Total debt service	..	..	125	317
IBRD	..	..	4	10
IDA	..	..	0	0
Composition of net resource flows				
Official grants	..	..	42	23
Official creditors	..	..	126	66
Private creditors	..	..	296	283
Foreign direct investment	..	..	152	355
Portfolio equity	..	..	21	0
World Bank program				
Commitments	..	..	151	4
Disbursements	..	..	44	21
Principal repayments	..	..	0	3
Net flows	..	..	44	18
Interest payments	..	..	4	7
Net transfers	..	..	40	11