THE MACROECONOMIC POLICY TRAP: LITHUANIAN CASE

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Abstract. *Macroeconomic policy is a major factor of country's wellbeing. It could be a catalist of the economic growth and could have detrimental impact on the economy. In other words, it may be both public good and public evil. The gist of the given article is to show how cognitive, fiscal and monetary factors influenced Lithuanian economy in both pre-crisis and crisis periods.*

Key words: *paradigms, individualism, holism, fiscal policy, monetary policy.*

Introduction: the cognitive trap

Lithuania undergoes a deep economic crisis, which is expressed in the steep decline of the GDP, rapid growth of unemployment, gaping budget deficit, degrading public sector, spreading underground economy etc. The reasons of these developments are multiple. They could be categorized into several groups. On the one hand, one could talk about the internal and the external factors of the crisis. On the other hand, one could discriminate between the paradigmatic and the practical, and finaly between the fiscal and the monetary reasons. Other groupings of the reasons could be named as well. In our analysis we will put emphasis on the three named groups of factors.

We advance a hypothesis that the crisis of Lithuanian economy was caused by the combination of the adverse internal and external factors, which led to the distortion of the regimes of governance and self-regulation on the macro level of the country's economy. The basic reason of the distortions in the macroeconomic policy of Lithuania was an individualistic understanding of the economic life. Premises of the methodological individualism was and continues to be the cognitive basis of the neo-liberalism and Washington concensus, of doctrines, which served as a philosophical foundation for the economic prescriptions used to large extent by the most of Lithuanian governments, IMF, by the World Bank, by the European Com-

mission and the Lithuanian authorities. Those prescriptions led to inadequate macroeconomic decision making both in terms of the monetary and fiscal policy (Stiglitz 2009).

Holistic approach is a relevant alternative to the methodological individualism. Holistic cognitive framework provides a wider, more comprehensive picture, panorama of the economic reality together with the richer and more flexible kit of the macroeconomic policy instruments.

Individualistic economic doctrines are explicitly or implicitly based on the premise that the only economic reality and the only economic actor is a self-interested individual. Accordingly, all kinds of communal actors, which are driven by the common, communal, public interests are figments of the imagination of the holists, organisists, collectivists (Degutis A.1998). All other characteristic features of the individualistic economic theories emerge from this individualistic premise. Protagonists of neoliberalism and libertarianism assume that the best version of the economy is a pure market, free of any intervention on the part of such supra-individual entities as local or state authorities. In other words, for them economy and market are synonyms. They tend to reduce the economic analysis to the microeconomics and are somewhat averse to the macroeconomic analysis, which deals with the aggregate, not individual, economic parameters. Individualistic theorists, politicians, businessmen, journalists failing to recognize the importance of the supra-individual realities have ex-ante negative attitude towards the regimes of the macroeconomic governance, towards the public sector and the public finance. For them all these phenomena are non-economic and distorting the "ideal" market system.

Proponents of the holistic approach admit the role of non-market, supra-individual regimes as economic (Gylys P. 2004) For them an effective macroeconomic governance in the form of the monetary and fiscal policy is a prerequisite for the normal functioning of the economy and well-beeing of people. In their view public sector is an indispensable part of the economic system supplying the society with the the complex variety of public goods. In this worldview the public finance, the budget as non-market, but economic phenomena conveniently takes its legitimite and honorable (individualists are budget averse) place in the economic thinking. For a consistent and balanced holist there is no problem to place side by side both the spontaneous, reactive market regimes and those of the macroeconomic governance.

Unfortunately, the new history of Lithuania is awash with the expressions of the radical individualistic thinking, which partly could be explained as a reaction to the extreme and coercive collectivism. Another explanation of the radical cognitive and ideological swing from one extreme to the other is the global dominance of the individualistic worldview in the times of the collapse of the soviet system.

We begin with this paradigmatic introduction being aware that the analysis of the macroeconomc practice of any country, including Lithuania, would not be complete without the examination of the cognitive foundations of this practice. Studying Lithuania's macroeconomic policy for the last twenty years we discovered that most

of deficiencies of this policy stems from the inadequate, ideology driven or overly politicized economic views. In other words, all these years our country was in a cognitive trap. On the one hand, it needs a clear and systemic picture of the economy. That gives the opportunity to make a relevant, valid economic diagnosis and to provide the working, effective recipes of the economic governance. But, on the other hand, our understanding of the economic reality is distorted by the ideological biases of one or another kind, by the attitudes stemming from the partial, not common, national interests. For instance, individualists and business people tend to identify the economy with business and market. This reduction of the economy to business and market has far-reaching negative consequences for the economic stability and well-beeing of the country. This cognitive deviation is the cause of "fogginess" of the economic picture and creates favorable conditions for the so called rule by stealth or rule by obfuscation, when in the misty social environment some partial interests are pursued at the cost of the macroeconomic interests of the country as the whole. When democratic regimes, which rely on genuine pluralism, on openness, transparancy are substituted by the regimes based on private interests, on misty cognitive premises, on stealth and obfuscation that means the political crisis, and crisis of the public sector at large. Being in crisis, public part of the economy fails to supply private sector with the required set of public goods. On the contrary, it imposes on the private economic agents a variety of public evils in the form of destructive macroeconomic laws, government decisions, irrational taxation etc.

We hope that we proved the importance of the paradigmatic side of the economic thinking and showed the dangers hidden in the economic philosophies. By doing this we had the intention to enrich the argumentation used in the traditional macroeconomic discourse. Now we can turn to more concrete and tangible issues of macroeconomy, namely, to the monetary and fiscal policy problems.

Monetary trap

In 1994 after short and vague discussion Lithuania introduced the currency board. Implicitly it meant the admission by the country that it was unable to cope with the problems stemming from the classical model of central banking. Drastic fluctuations of the exchange rate of the national currency litas, fragility of the young, emerging financial sector were the main arguments for the transition from the classical central banking to the non-classical model of the currency board.[1]

There was one major external factor for this transformation – some experts from the West and first of all a well known libertarian S.Hanke, who managed to persuade the Lithuanian leading politicians about the advantages of the currency board, vehemently advised to adopt this model of the central banking as an effective cure from financial turbulations.[2] One could as-

[1] Until now some Lithuanian economists, not nly people from LFMI, think that the adoption of the currency board was the wisest decision made by Lithuanian authorities in the sphere of monetary policy (Kuodis R. 2002, p. 99)

[2] Although in his recent interview Steve Hanke argues that „a currency board was widely discussed among the public and government officials" in the same interview he admits that for then Lithuania's Prime Ministre

sume that there were two groups of arguments supporting the given advice. Firstly, advisers from the West were aware of the shortage of local human capital needed for the execution of a normal central banking policy because people employed in the Lithuanian banking sector had a soviet economic education and a very limited experience of working in the conditions of market economy. It meant that these people had scarce understanding of the normal banking system and that the political leadership of that time failed to send to the West a group of young and middle-aged economists for an intensive re-education to fill the profesional gap. Therefore learning by doing, the method of trial and error were the prevailing practices in the banking system of the Lithuanian bank as well. It was a very expensive experience and some people assumed that currency board as an automatic regime could compensate and improve the situation.

In the longer run, however, it was more and more evident that alongside with the practical considerations of western advisers another – ideological – motive existed. At that time individualism in its different forms (libertarianism, neo-liberalism and Washington consensus) was dominant in the global economic philosophy. And currency board fitted quite well into these ideological and conceptual perceptions. The post soviet area in the East and Central Europe was a good polygon for individualistic experiments. The ideological pendulum swung from one extreme – radical collectivism to another – aggressive individualism and there were almost no intellectual resistance to the individualistic projects.

The system of the classical central banking allows the country to pursue a discretionary monetary policy i.e. to react to the changing parameters of the economic life (recession, rampant inflation, unnaturally high unemployment, weak export and current account deficit). In other words, classical central bank is able to apply different combinations of proactive measures and to a certain extent govern the macroeconomic variables. But governance, proactive, discretionary behavior of the state institutions at that time failed to be the terms and concepts of the decent professional parlance for the individualistically thinking mainstream or the orthodox economists. Spontaneity, unfettered market or at least systems of the fixed, strict rules were in vogue.

Being devoid of the proactive, discretionary elements currency board meets the requirements of the orthodox, mainstream thinking. When national currency exchange rate is fixed, when national central bank fails to be able to apply open market operations, to undertake quantitative easing, to influence the credit sphere by the change of discount rate, when it fails to be the the lender of the last resort it is unable to intervene intocountry's macroeconomic life and thereby to help the government to deal with the economic challenges neither in times of economic overheating nor in periods of recession or depression. Acting according to the currency board rules the central bank fails to be in a position to influence the monetary base, i. e. the quantity of money circulating in the economy and to influence the

A. Šleževičius to make a final decision on the issue the lunch time was sufficient, (Hanke S. 2009). As a former member of the Lithuanian government we could witness that the procedure of adoptingthe currency board was neither comprehensive, nor well discussed.

national level of the interest rates. Finally, the country may not adapt smoothly to the external trade conditions through the flexible exchange rate. Fixed exchange rate means that the regime of automatic adjustment of the exchange rate to the external economic environment fails to exist and policy makers should be willing and able to take the political risk of the usually controversial decisions, for instance, devaluation of the national currency.

Fixed exchange rate, which is unnecessarily tied to the currency board (it existed both in gold standard and in Bretton-Woods system), constitutes a certain paradigmatic paradox in the currency board in terms of the individualistic economic thinking (Vinkus M. 2002).[3] The most progressive thinking along these lines are purely spontaneous regimes, based on the free, unrestricted competitive actions of the economic agents. Fixed exchange rate is the result of the decision made by the state authorities (in Lithuania's case by the special committee). Flexible, floating exchange rate results from the spontaneous interplay of the market forces i. e. supply and demand of the given currency on the international currency markets. In this sense, the regime of flexible exchange rates to larger extent is part of the pro-market, neo-liberal thinking. Nevertheless, due to other attractive features the currency board was a widely promoted model by the mainstream economists.

Lithuania, Estonia, Bulgaria and with some peculiar, specific characteristics Latvia in the face of the economic and financial instability adopted the currency board. After the adoption of the currency board Lithuania settled several problems. Volatile fluctuations of litas ceased to be the problem for the country which meant that business and households could act and live in stable and predictable currency conditions. The danger of the excessive, uncontrollable money printing in the times of budgetary deficits and as a result of the threat of rampant inflation disappeared. Thus the financial system became more transparent and stable. Public confidence in the financial institutions slowly, but constantly was on the rise.

Together with those positive developments several problems and deficiencies emerged.[4] Firstly, Lithuania pegged its litas to dollar. It could be treated as miscalculation. Estonia's choice in our view was more prudent and rational – they pegged their currency Kroon to the German mark. The disadvantage of the Lithuanian choice was concealed in the fact that our major trade partners were in the West Europe, when the USA was not such important trade partner. Since Germany was the main engine of the European markets, pegging of litas to the dollar meant bigger exchange rate and risk. In fact, this risk was translated into the real losses for local exporters when the dollar in the second half of the last decade of 20th century began to appreciate. It was a beneficial trend for the powerful importers (first of all the

[3] M. Vinkus was probably the first Lithuanian economist who noticed this discrepancy between the free market theory and the concept of currency board with its fixed exchange rates. The latter is a result of political decision, but not an outcome of the interplay of the suply and demand forces in the markete (Vinkus M. 2002).

[4] These deficiencies were recognized in the second half of nineteen nineties by some people in the Bank of Lithuania. They analysed the shortcoming of the currency board and discussed the possibility to return to the classical model of the central banking (Lietuvos banko pinigų politikos programa. 1997 sausio 16).

emerging shopping malls) but inflicted heavy losses on the enterprises, which exported their goods to West Europe and other regions and territories, where local currencies depreciated against the dollar. In general, the rise of the dollar and as a consequence the appreciation of litas, had negative impact not only on some sectors of economy, but on current account as well.

In the case of the adoption of the German mark as the basic currency the rise and fall, apreciation or depreciation of the latter would have had more neutral impact on the Lithuanian economy and current account because litas would have been fluctuating together with the currency to which it was pegged and the trade conditions in currency terms with its main European partners would have been stable. Exchange rate risk, of course wouldn't have disappeared altogether – trade with other, and first of all non-European trade partners, would have stayed vulnerable. But the gains from the stable and transperant currency conditions with the main trade partners could have offset the possible risks and losses. Another advantage could have been the automatic re-pegging of litas from deutschmark to euro and avoiding of some nuisances, though minor, in the process of re-pegging litas from dollar to euro. In this sense for Estonia the process was smoother than for Lithuania, because it was more automatic.

All these negative side effects of choosing dollar as the basic currency were overlooked by both Lithuanian authorities and the advisers from the West. So far there is no neutral analysis of this decision. But the main shortcoming of the implementation of the currency board was the failure to foresee the negative economic scenarios in the form of overheating, recession, depression, big current account deficit etc. when the need for the discretionary monetary policy becomes more evident, some economists would say acute. At least part of the problems could have been avoided in the case of Lithuania's successful accession to the eurozone in 2007. Unfortunately the country, which had otherwise good macroeconomic indicators and met Maastricht criteria in terms of the budget deficit, the public debt was unable to conform to the requirement of the inflation criteria. Although the difference between the required and the actual inflation rate was tiny, only one hundredth per cent, EU governing bodies decided to apply strict criteria and Lithuania was left outside the eurozone and, as later developments showed, in a vulnerable position .

Some analysts say that the Brusels' position was too hard and inflexible and that the possible negative consequences of such hard stance were not properly assessed (Dulkys A. 2008) But the possible answer to this criticism could be the following: only a few economists predicted the global economic crisis. The majority of economists and politicians failed to contemplate the possibility of the implosion of the real estate bubble, credit crunch, and the economic bust.

Economic crisis, euro and the currency board

Though complacency in pre-crisis period dominated in regard of global economic perspective, warnings addressed to the Baltic States by some Western economists

were issued periodically. Even in the time, when L.Balcerowicz named Lithuania a Baltic tiger, some analyst contemplated the scenario of hard landing for all Baltic countries, Lithuania included.

For several years some western economists warned that big and increasing current account deficit endangers the very sustainability of the money system with its currency board, that currency board itself is not the automatic and absolute guarantor of the monetary stability.

Surprisingly enough, but even those economists, who critically assessed the monetary situation in the Baltic countries failed to pay attention to the loophole in the currency board arrangement, which let rapid dollarization of the Baltic economies happen and which was the major cause of the real estate bubble and overheating of the economy.

The process of the dollarization contradicted the fundamental principles of the currency board as a regime of the strict monetary policy. Dollarization is the phenomenon expressed in the increasing use of foreign currency (dollar, euro etc.) in parallel or instead of the local, domestic currency. It can be formal and informal. Informal dollarization was widely spread in the post communist countries especially immediately after the collapse of the Soviet Union. In Lithuania the US dollar was a popular means of economic transactions for some years and especially in the real estate contracts and purchases. In length of time local currency regained confidence in the eyes of economic agents and extent of dollarization gradually diminished. The new wave of dollarization was catalyzed by the massive flow of euros from the Western, mainly Scandinavian, parent banks to their subsidiaries in Lithuania. It was expressed in the upward spiral of the growing expectations, rising credit demand and credit supply[5].

Many Lithuanians were overwhelmed by the belief that accession to the EU in 2004 and rapid joining of the eurozone in the near future will be translated into the swift equalization of the prices for real estate (land, houses) throughout the whole EU area. For ordinary Lithuanian this equalization of prices meant the rise of value of the real estate. These prevailing expectations of the rise of prices for land and houses was the main psychological factor of the massive investment into the real estate and the creation of the housing bubble. But expectations are not sufficient to blow the bubble. Real money is needed. Only at the beginning of the process and in the decreasing manner proportion these investments were financed from the private, household savings in litas. With the growing readiness of the banks to provide credits, with the encouraging signals from the government and in the absence of warnings on the part of the Bank of Lithuania, of local economic analysts and experts (the majority of whom are analysts of foreign owned commercial banks), economic actors both on the business and the household sides accelerated the race for a better plot of land, for the house, office building etc.

The amount of the national currency litas was limited due to the currency board restrictions on the expansion of the mon-

[5] Some economists tried to warn the Central and Eastern European countries about the high risk of borrowing in hard currency (Rosenberg Ch. 2008), but these warnings were overdue and went unheeded.

etary base and due to the limmited amount of local savings held in the banks. But no serious restrictions, constraints existed on the flows of euros coming from the Western parent banks to their subsidiaries in Lithuania. These flows made the real estate bubble from possible to real.

People are often tempted to be "prophets afterwards", but at least in retrospective one can state that the major international and national power centers, EU institutions, IMF, foreign owners of Lithuanians banks, Lithuanian government, Central Bank authorities, local economists and media failed to organize an open and free discussion on the issue and thereby to provide proper diagnosis and to use appropriate measures to stop the process leading to the creation of the real estate bubble. Ultimately the failure to predict and failure to decide led to the implosion in the housing and construction sector with the dire consequences for the economy as a whole.

With the freeze of real estate market the construction industry and contiguous sectors suffered sharp decline (construction industry almost 50 %) dragging down the whole national economy. With the shrinking of the GDP, with the rise of unemployment, falling salaries and wages with the increasingly pessimistic expectations of the population, with elites' inability to react properly to the worsening macroeconomic situation, the country is in a steep downward spiral. Unfortunately the procyclical behavior of commercial banks for quite obvious reasons – they are driven by private interest to minimize risk and losses – exacerbates this downward tendency. Commercial banks are afraid to take risk and provide loans to businesses and households, although they readily provide credits to the Lithuanian Government suffering the widening budget deficit. Quite recently one of the richest local businessmen B. Lubys publicly complained that even he was refused the loan.

Credit crunch in the country means the deepening, strengthening anaemia for the economy. Economic blood circulation is in great jeopardy. In these circumstancies one could think over the quantitative easing and discount rate regulation. Many countries, trying to withstand negative macroeconomic tendencies, apply these monetary instruments. But these instruments are not available in the Lithuanian state. Currency board precludes such policy. That is why the country gets into another vicious economic circle. If previously the circle was nourished by the high positive expectations and the expansion of the money supply mainly through the dollarization of the Lithuanian economy, today the circle is characterized by the low and very negative expectations of the economic actors (business, households, etc.) and sharp contraction of money supply expressed among other things in the inaccessibility of credits. All this is addition to the inadequate fiscal policy led to tumbling, contraction of the GDP, rising unemployment, intensifying social and political tension, paralysis of the decision making regimes and so on. Accute shortage of credit money is paralleled by the high interest rates for loans made in litas. Officially it is explained by high Vilibor, but implicitly – explicit discussion on this issue is the political tabu – another powerful factor is at work – by the exchange rate risk. Banks want protect at least partially

to their capital revenues and deposits from the possible devaluation of litas. Although most politicians, Central Bank, elite of the country are mobilized to keep the fixed exchange rate with euro (1euro =3,4825 litas) nobody can guarantee that this mobilization will bring desirable results and the devaluation will be avoided.

High interest rates for loans denominated in litas mean that the credit is pricey and therefore unaffordable for many business people and households. Thus credits in litas for economic agents are doubly problematic – it is inaccessible even in the case of a solid collateral and it is very expensive if an agent overcomes the first obstacle suggesting an acceptable one.

Loans in the foreign currency it – has to be reminded that in Lithuania the main foreign money is euro – are less risky to the banks, but are risky to the clients. In the case of devaluation of litas the money value of their borrowings made in euros but expressed in litas would increase. Having in mind that nobody anticipates the devaluation of litas against the euro in 5–10 % band and calculates much higher figures, the exchange rate risk seems for many to be a considerable or unbearable.

Thus firms and households are in some kind of the monetary trap, a blind alley. Some of them badly need new loans. But for part of them the loans are unavailable altogether, because of too high requirements for the collateral. For others, they are too expensive if they are received in litas or they are too risky if received in euros.

This trap and the paralysis are deepened by the fact that keeping litas pegged to euro means a considerable, sizeable sacrifices for some groups of people and economy as a whole. On the one hand, fixed litas against euro does not mean an absolute stability of the exchange rate vis a vis other currencies. After depreciation of the Polish zloty, Russian rouble and Belorussian rouble and some other currencies the nominal exchange rate of litas has risen against these currencies. In its turn, this rise was translated into the worsened conditions for the country firms exporting their goods into the respective countries. That *ceteris paribus* adversely affected the current account, the financial results of exporters, the employment in export oriented firms etc. On the other hand, it creates pressure to cut costs of production to maintain the international competitiveness of business. As a result, wages and salaries, working places become the target of the business policy of cost reduction. That leads to the fall of income, unemployment, to the some kind of social dumping in terms of international competition, race to the bottom in terms of living conditions of ordinary people etc.

Due to the unwillingness of the government to take the political risk and to consider the devaluation of litas seriously, Lithuania resorted to the policy of depreciaton of labor force and public sector. Cheep labour and cheep public sector is the price, which the country to some extent ruled by stealth (most of the population are not fully aware of the fact) is paying for the policy of fixed exchange rate of litas. Is it worthwhile to make such a sacrifice and to pay such a price? What is better – devaluation of litas or devalution of labour and public sector expressed in the social dumping and race to the bottom. These questions are beyond the public discourse. It is a kind of taboo in

the Lithuanian society. The same applies to one more question: what is the probability that the policy of maintaining the fixed exchange rate of litas against euro at any cost will fail and despite our sacrifices the litas will be devalued?

The political economy of the fixed exchange rate

One of peculiarities of the Lithuanian society is the fact that only part of interest groups and power centers understand the micro and macro economic outcomes of the possible alternatives concerning the exchange rate policy. Banks in this sense are very well informed and are well organized. On the other hand, interest groups, which are aware of their own micro interests, fail to comprehend or simply ignore the macroeconomic consequences of the monetary policy pursued by the ruling elite. In addition, the international environment in which this policy is executed is vaguely perceived.

As a result, the monetary situation could be described as uncertain and foggy at best. With some interests groups seeking to maintain their benefits given by the existing situation, with less powerful groups unable to define and defend their interests, with the general public unaware of macroeconomic consequences of different monetary policy models, the situation seems both gloomy and unclear.

To make the picture clearer we shall examine the situation in terms of the political economy, i. e. in terms of interests and actions of the various power structures – banks, business, trade unions, households and the government.

Banks are the major power structure in our country. Mainly foreign they have additional power, leverage because Lithuanian authorities are afraid of the possible negative international reaction to the steps, which could seem unacceptable to the foreign owners and politicians. Natural interest of banks is to mainatain their stability and profitability. Due to the fact that big part of their credit resources comes from the paternal, mainly Scandinavian, banks in the form of euros they have strong microeconomic interest to keep litas at the present exchange rate. In the case of success, such a policy would preserve the status quo and foreign banks would avoid losses caused by the devaluation. First of all, they would not loose revenues expressed in litas. After the devaluation converting revenues earned in litas to euros would mean less than previously euros from the same amount of litas. That is the factor, which is important and relevant for all foreign investors planning to repatriate their revenues to their respective countries.

Interests of another power structure – business – are split. Those firms, which to a large extent depend on the imports are satisfied with the existing situation. In their trade with the eurozone countries they have stable exchange rate conditions, but trading with non-eurozone countries like Russia, Poland, Belorussia and others due to recent depreciations of their currencies importers get tangible additional gains from factual rising of the value of litas – they have to pay smaller amount of litas for the same volume of imported goods. Therefore mighty commercial firms like “Maxima”, “Rimi”, “Norfa”, “Iki” who are big importers naturally are interested in keeping the existing exchange rate. Devaluation of litas would mean for them di-

minishing, shrinking revenues from import operations.

Export oriented businesses have opposite interests. Although they were quite satisfied with the fixed exchange rate with the euro because it meant stable and predictable monetary environment, minimal exchange rate risk, with the beginning of the global economic crisis and shrinking demand on the international markets relatively overvalued the litas (Harrison E. 2009) and depreciation of the currencies in some neighbouring countries turned into the anxiety and losses for many exporters. If they produce goods both for the local and external markets it means that they have to withstand a double blow. Firstly, with strong litas it is difficult to compete on the contracting foreign markets and when some important trade partners allow their national currencies to slip down and secondly the substantial fall in the production and consumption in Lithuania turns into falling profits, growing redundancies, partial use of the available material, technical and other factors of production.

That is why for the most exporters devaluation of litas would be a quite desirable decision, which would allow to at least partially ease the pressure on them and get some competitive advantage in the monetary terms. As has already been mentioned, it is not the first time that Lithuanian exporters are in a disadvantageous situation – after 1994 when litas was pegged to the dollar and dollar rose against the European and other important for Lithuania currencies, exporters of the country suffered massive losses. Today the situation is similar.

But both in the past and in the present the voice of country's exporters is hardly audible. The explanation might be double. On the one hand, some important exporters are at the same time big importers. For instance, big exporter "Jonavos Azotas" led by the president of the Lithuanian industrialists Bronislavas Lubys exports a sizeable share of produced fertilizers, but at the same time it imports a huge amount of natural gas from the East. Thus such firms have conflicting, and contradictory interests – as exporters they, probably, would press for the devalued litas, but as importers they would prefer to keep the litas pegged to the euro at the stable exchange rate..

Another explanation of exporters' silence could be ideological and political. As far as the issue of the devaluation is considered to be a taboo and those who violate this taboo risk to be ridiculed as unpatriotic, nobody from the exporting business circles takes the risk to defend their interests publicly.

Among those, who have the interest to maintain the status quo are business people and households, which borrowed from the banks in euros. While for most of them earnings come in litas, but repayments must be done in euros, the devaluation of the litas automatically turns into the growth of their debt. If the devaluation of the litas were significant, the rise of their liabilities would be substantial too.

Lithuanian trade unions are keeping low profile position on the future of the litas. It could be explained by a twofold reason – leaders of the labour organizations lack appropriate knowledge and they are afraid to break the taboo imposed on the society by the country's elite – mass media first of all. Trade unions, generally speaking, should be against the sacrifices

caused by keeping the litas pegged to the euro at the fixed exchange rate at all costs when costs are formidable. Dramatically falling, dropping wages and salaries, rising unemployment, worsening situation in the public sector means that the quality of life of the working people is and will be on the decline. Therefore trade unions should be more expressive in arguing for a more comprehensive public discussion on the currency issues and in this sense contribute to the more balanced approach towards the problem of devaluation.

Political structures – the government parties, the president of the country – are not vocal on the issue as well. Though there were some sporadic efforts on the part of of some politicians to challenge the existing monetary order and to raise doubts on the relevance and the efficiency of the currency board, they were smothered by the cold, even hostile reaction of mass media and political elite. Thereby, a formal political consensus prevails on the political scene. But if one takes a look at the political realities one can easily disclose that this official unity is complemented by the unofficial, disguised political pluralism on the issue. We find out from our informal conversations with the MP's belonging to different parties that part of the politicians are well aware of the vulnerability, fragility of the existing monetary situation.

Looking at the alternative scenarios for the developments in the exchange rate policy from the standpoints of the political leadership, one can point out several major factors of the looming political decisions in the fields. First of all, devaluation of litas would mean an automatic rise of state's debt denominated in euros or other hard currencies. This is the most obvious, visible argument against the devaluation of litas. Less obvious is another factor – devaluation of the currency brings the advantage to a small and export-dependent country like Lithuania in terms of international trade. With the devaluation of litas exporting sector of the economy *ceteris paribus* could recover, igniting the recovery, though not immediate, of the whole chain of adjacent sectors of the economy, softening the situation on the labour market etc. Better perspectives for the balancing of the current account and for the economic growth could open, the appearance of the spectre of deflation could be less probable. In other words devaluation of the national currency, as the international experience shows, could be treated as a remedy both in terms of domestic economy and international trade. The example of Iceland, which currently experienced the major crisis and as a result significantly depreciated its currency, is quite instructive for our country. Though the situation there is still very serious, some signs of recovery appeared. For instance, with cheaper local currency the country attracts tourists for which earlier Iceland was too expensive (Harrison E. 2009).

The trade off between the devaluation of the currency and "devaluation" of labour and public sector is not easy to decide but one should be aware of the risk that choosing one of the alternatives not guarantees that another alternative will be totally neutralized. For instance, if the decision was made that country continues the policy of social sacrifices in the name of litas stability no one could be sure that devaluation of litas would be avoided. Even more – the probability of such a scenario stays high.

Therefore there are propositions to adopt the euro immediately (Wagstil S. 2009).

It is true especially when Latvian factor is taken into account (Latvian contagion 2009). Majority of Western analysts agree that this Baltic country could be forced to devalue its currency despite its big social sacrifices. If it were proved true then the chain reaction of devaluations through the Baltic region would almost certainly begin. It could be explained by the political, psychological and trade factors. But the main factor would be currency board regime.

Fiscal policy trap: part one

The major peculiarity of the Lithuanian fiscal policy is its one-sidedness, its distorted understanding by the country's elite. This cognitive specificity to a large extent is caused by the continuous, persistent indoctrination of the society in the individualistic values attached to by the Lithuanian Free Market Institute (LFMI) and mass media. It took place in the the conditions of the ideological monopoly, when the cognitive competition on the part of future more holistically minded academic circles, trade unions, left-wing parties was weak or nonexistent for the media for years. The main power structures were able to persuade a considerable part of the society and the majority of elite people that the best state financial policy in all circumstances is to cut taxes, especially direct ones, and slash public expenditure as unproductive to limit public investments, which allegedly crowd out private investment.

This libertarian doctrine of public financies is consistent with the presumptions of the individualistic economic paradigm. In this paradigmatic framework, as was shown before, there is no place for the joint communal actions and public goods, therefore the state and the public financies fail to fit in to this individualistic picture of the economy, which for a libertarian thinker and politician is identical to the market. In other words, market encompasses the whole economy and all non-market elements of the social life are assumed to be non-economic, therefore economization of this life should be achieved through marketization and thereby privatization of the public sector.

Public budget should be as small as possible, budget deficit extinct. Staying inside the individualistic paradigm it is difficult or even impossible to challenge these pillars of the individualistic thinking but from the holistic perspective they are vulnerable and feeble, because from this perspective the economy could be seen as a unity of the private and public sectors, economization not necessarily coincides with the marketization and privatization and could be achieved through socialization (nationalization). In the framework of the holistic economic thinking the state and production of public goods are not marginalized. Moreover, holists could see that the effective production of private goods is in many cases impossible without the effectively functioning public sector, that public investments especially into the infrastructure do not crowd out private investments, but on the contrary enhance, catalyse them, that small budget is not necessarily an optimal one and that in some cases deficit in the public finances is the expression of a prudent fiscal policy, when the government in times of recesion is trying to keep the economy afloat and applies

the set of measures involving tax cuts and higher expenditure as the means of discretionary fiscal policy.

Classical fiscal policy doctrine introduced by J. M. Keynes and developed by his followers suggests that taxes and state expenditures can serve two purposes – to supply the society with goods, which couldn‘t be effectively produced by the market regimes and to be the instrument in the hands of the government to regulate such macroeconomic parameters as the GDP growth, inflation and the unemployment level, regional or sectorial balancing of the economy. Employing a classical fiscal model in different conditions the Government could cut and raise taxes, expand or cut its expenditures. Such government is aware of the impact of the automatic stabilizers of macroeconomy .

Lithuanian version of the fiscal policy differs from the Keynesian one substantially. Firstly, it based on the premise that in all conditions the best and universal measure for the economy is tax cuts and the reduction of state expenditure. Mass media, LFMI and other power structures promoted this fiscal philosophy even in the conditions of overheated economy, whilst the classical model of fiscal policy would suggest tax rise and, probably, the reduction of state expenses. In the period of the excessive, rapid economic growth the application of Keynesian approach would allow to transform, tune up and to prepare for more difficult conditions the system of automatic stabilizers first of all in the form of progressive taxes and prudent rules of distribution of transfer payments (allowances, pensions, unemployment benefits etc). But the fragmented coalition of the center-left, center and liberal parties, which ruled the country from 2004 to 2008 failed to comply with this model of the fiscal policy and pursued the policy, which suited more the neo-liberal rather than Keynesian fiscal policy.

Being under a mighty ideological pressure of pro-business interest groups and mostly liberal mass media, the ruling coalition of the time, like most of the previous governing political majorities, were not able to change the philosophy of the public finance and increase the financial resources needed by the public sector. That meant that social, educational, cultural, scientific, healthcare needs of the society were under-financed and therefore only partially satisfied. Such degradation of almost all spheres of the public sector led to the gradual and hidden, undiscussed properly as it was, privatization.

In the period of the rapid yearly growth of the GDP, which in 2007 and 2008 was close to 10 per cent there were two opportunities to improve the country‘s fiscal situation. First, to increase budget revenues through the essential reshuffle of the system of taxation, which was and still is to a large extent regressive, i. e. the biggest part of the tax burden was (and is) laid on the shoulders of worse-off taxpayers. Implementation of the progressive taxes on labour and capital income, introduction of the taxes on the real estate (especially on the second, third etc. house or flat owned by the familly) rising of taxes on dividends and other measures could add to the tax revenues and could make the system more fair, less regressive. Such change could have opened the possibilities to finance better the lean public sector and/or to ac-

cumulate the budget surplus in the special fund, which could serve as a reserve from which the budget deficit could be financed in difficult times of recession or crisis.

If such policy succeeded better financed public sector would create better conditions for the private firms to compete more effectively on the international markets especially in the long run. As global experience shows, countries with well developed and effective public sectors have advantage over the countries with the under-developed, starved public sector which is not able to produce the required volume of quality public goods and thereby fails to create favourable, competitive conditions for the private firms, to withstand harsh and tough rivalry in the international markets. Instead of developing public preconditions and good public environment for business in terms of social and material infrastructure and thereby enhancing its competetive power Lithuanian authorities overwhelmed by the cognitive and ideological inertia involved themselves into the international tax competition, with its tax poaching, race to the bottom, social dumping etc. (Gylys P. 2006) In the long term perspective it means the diminishing economic power of the country, its ability to produce an optimal, both in terms of quality and quantity, set of private and public goods. In other words, such policy had and will have negative impact on systemic measurements of country's well-being, for instance on Genuine Progress Indicator (GPI).

If the requirements of classical fiscal policy were observed, one additional gain could be obtained. If the prudent, balanced extention of the public sector through rationalization of its structure and better financing, were achieved, the incremental increase of tax revenues by several (2–3) percent of the GDP (more rapid growth of taxes are limited by the public sector's ability to absorb large sums of public money in a short-term because of the danger of the unproductive, corrupt growth of the public sector, with misuse of public money, although in the case of prudent fiscal policy this danger could be neutralized by the accumulation of 'excessive' budgetary proceeds for harder times) would have a restrictive, cooling effect on the overheating of economy, on factors creating the economic bubbles.

A bigger public sector among other things could have a stronger stabilizing effect on the economy. If the government, local authorities, schools etc. have more financial resources, they comprise a larger portion of the aggregate demand and in the period of recession or depression this greater demand means better chances for business to sell their products and services to keep their workers employed etc.

Thus this cooling and stabilizing impact of various fiscal measures harnessing business involved in the bubble creation could, at least to some extent, have converted into a less drastic implosion of the Lithuanian economy in 2009, when after the parliamentary elections the new rightwing coalition formed the government and tried to change quite dramatically some instruments and elements of fiscal policy .

Fiscal policy trap: part two

New governing coalition came to power at the end of 2008 and tried, one could say hastily and recklessly, to adopt the budget

for 2010. The main idea of the budgetary planning for the coming year was by all means to avoid the budget deficit and to maintain open the possibility, to enter the eurozone in the near future (2–3 years time).

But the measures taken by the ruling coalition were self-defeating. At that time it was clear that the economic crisis was looming, though the actual situation was still quite satisfactory. Fiscal logics, required to concentrate on the steps, which would soften, or neutralize the negative international factors and at the same time would encourage local business activities. Keynesian macroeconomic prescription in these circumstances would be the following: look for the optimal combination of more active than usual governmental participation in the economy, which might require additional financial resources and consider the possibility of some tax cuts, tax exemptions for some groups or some sectors which are the most sensitive to the international environment, business fluctuations and so on. In parallel, opportunities for a considerable borrowing inside and outside the country had to be examined and preparations for such step had to be made. At the same time all measures of toughening regulatory conditions for the 'undisciplined' small business would be postponed until better times.

One of the indispensable directions of these preparations had to be open and intensive consultations with EU political authorities and IMF leadership of the fiscal and monetary strategy in the face of the approaching economic downfall. Lithuanian economic downfall from the very beginning had to be presented as a serious threat both to the country and to the whole Baltic region. In the ideal case from the very outset the Lituanian leadership had to argue that IMF traditional recipes based on the principles of Washington concencus would be of no use. One has to admit that the political and ideological environment was not totally conducive to such promotion of the Lithuanian case on the international arena – the main international players were overwhelmed with much more pressing global and regional issues, and the international ideological climate was still saturated with the individualistic, neoliberal values. Although from the autumn of 2008 a noticeable ideological shift from the individualism to holism took place, since part of the economists, journalists and politicians discovered that one of the root causes of the collapse of global financial market was the wrong and irrelevant economic paradigm employed by the major global power structures.

Notwithstanding these uncertain circumstances, early efforts on the international arena could bring at least some results. The historic G20 London meeting in the beginning of April 2009 witnesses that those efforts had the chance to succeed. At that meeting it was explicitly and publicly anounced about the end of the era of Washington consensus with its infamous procyclical recipes first of all in the form of the reckless budget deficit reduction. Ruling coalition failed to consider these options seriously. Instead, they have chosen to act on their own, to increase most of the taxes (except income tax, which was cut from 24 to 21 per cent) and to axe many items of the budget expenditures. Profit taxes and taxes on dividends were increased from

15 to 20 per cent. Value-added tax (VAT) rose from 18 to 20 per cent. Instead of using expansionary fiscal policy the authorities decided to apply the restrictive fiscal policy. The restrictive fiscal policy in the conditions of the looming economic recession for a Keynesian is a sheer nightmare, but it is not tragic for the individualistically thinking neo-liberal. While a Keynesian treats the rise of taxes and the limiting state expenditures as steps, which lead to the diminishing aggregate demand and finally the contraction of the national product, the neo-liberal camp, admitting that such measures could cause the decrease of the aggregate demand argue that the latter development would only be translated into the lower prices, but wouldn't affect the level of the production and the volume of the GDP and, thus, unemployment and other macroeconomic indicators.

Since the main advisers, who helped to draft the election program for the conservatives and other coalition partners, were economists, who adhere to the neo-liberal principles, and the ideological environment of the country was saturated with the individualistic values, the authorities were quite sure that they would achieve a triple goal – they would be able to balance the budget, to maintain the economy afloat and would not ruin the perspective of adopting euro in the near future.

Economic realities overturned those forecasts and beliefs – neither of the goals, to a large extent due to the irrelevant fiscal policy,were proved to be valid. The budget deficit is gaping and in 2009 will reach approximately 10 per cent of the GDP. That means that indebtedness of the country will grow by the same percentage of the GDP. In several years the public debt can exceed the limit of 60 per cent of the GDP. Just a year ago it was about 15 per cent of the GDP. Both these indicators – budget deficit and public debt are crucial for maintaining alive the country's hope to join the eurozone soon. The main reason of these tragic budgetary developments was steep decline in business and production. GDP according to some estimations in 2009 will fall by 15–18 per cent (in yearly terms). This fall not only caused budgetary complications, but was a catalyst in the sharp rise of unemployment, which by the end of the year will reach 250 thousand (registered). It will take several years, provided that adequate macroeconomic policy is ensured, to get out of this vicious circle.

Let's imagine that the Lithuanian authorities were more rational, active and flexible both on the domestic and the international stage. It was able not to touch taxes at all, and rationalize its expenditures. In parallel it could negotiate with the EU and the IMF and prepare to borrow if not from the international organizations, then from the private creditors (we are borrowing from them anyway). The earlier the borrowed money had been used as a stimulus money the less precipitous the economic downfall could have been. Then the drop in the GDP could be ceteris paribus (the negative impact of the inflexible monetary policy should be taken into account), say, 8 –10 per cent instead of 15–18 per cent.

A big part of the population fail to understand that a big part of the blame should be put not only on the international factors, but on the inadequate fiscal policy as well. Ironically, budgetary transformations were aimed at the reduction of the budget deficit

and at putting constraints on the growth of the public debt. The result is totally the opposite. And the main reason for this is the misleading economic views of those, who made macroeconomic decisions. These views could be given the name of the public evil, which has a huge destructive power and which could be attributed to the anti-economy (Gylys P. 2005). Nowadays the saying that the devil is hiding in details is widely used. We would like to suggest the new version of the expression – small devils are hidden in details, but the biggest of them are in paradigms, visions and strategies. Big devils are big destructors.

Conclusions

Lithuania is in a precarious situation both economically and politically. By some estimations in 2009 the country‘s GDP can fall by 15–18 per cent. That means huge social and political strains for the country which just a few years ago was named a „Baltic tiger“.

Only part of the blame for the situation could be attributed to the global economic crisis, which has nothing to do with the Lithuanian political leadership. Another part of the blame could be put on the country‘s ruling elite. Blind faith in the teachings of the individualistic gospel, the lack of economic knowledge, prevailance of various irrational taboos on the public arena led to the situation in which many factors of the economic life were not profesionally and democratically discussed. We state this being aware that some issues, for instance, devaluation, are very sensitive, psychologically contagious and deserve some degree of confidentiality.

Public and political discourse related to the macroeconomic policy alternatives takes place in the conditions of the democratic deficit and of intensive indoctrination of the population in the individualistic values. The latter is expressed in *ex ante* negative attitude towards the role of the state in economy, towards the discretionary monetary and fiscal policy and in favour of non-interventionist approach and fixed rules. All this led, in our opinion, to much deeper economic crisis than in the majority of other Central European countries, which adopted more rational and flexible macroeconomic policy. Their monetary and fiscal systems, although not without shortcomings, at least partially cushioned, and weakened the negative impact of the global financial crisis and the global recession of the economies and therefore their GDP have fallen by 5–6 per cent i. e. by approximately half of the Lithuanian GDP contraction.

Looking at the Lithuanian economic crisis through the holistic lens one could realize that not reducing the economy to the market, but perceiving it as a system comprised both of private and public sector, could give the possibility for the exit from the vicious circle of the mutual enforcement of the GDP decline and the degradation of the public sector. Therefore the philosophy of the combination of the proactive, discretionary behavior of the state institutions and self-regulatory, spontaneous activities of the private economic agents could bring the country better results to the country than blind faith in the self-regulating markets and an outright denial of states role in the economy.

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