



NATIONAL AUDIT OFFICE OF THE REPUBLIC OF LITHUANIA

PUBLIC AUDIT REPORT PUBLIC DEBT MANAGEMENT

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SUMMARY

The National Audit Office of Lithuania (hereinafter referred as NAOL) assessed the efficiency of the debt taken on behalf of government management strategy and public money (including borrowed funds) management in 2006. Supreme audit institutions shall pay sufficient attention to the management of public debt so far as it is their duty to promote due activities in the field of public debt control ensuring the transparency of public debt management and disclosure of all liabilities of the government.

During the last few years the public debt to the Gross Domestic Product (GDP) ratio was decreasing. The Lithuanian public debt-to-GDP ratio by the end of 2006 was 18.2 per cent (one of criteria set forth by Maastricht Treaty sets the level of public sector debt not to exceed 60 per cent of GDP or otherwise it should rapidly and consistently decrease) and thus is one of the lowest among EU member states.

The main objectives, directions of public debt management, debt structure priorities, and limits of liabilities up to 2009 are set forth in the Description of the Government of the Republic of Lithuania Medium-Term Borrowing Policy Guidelines¹. Although the reduction of debt is programmed in provisions of the Law on Public Debt and documents on fiscal policies, the above regulations do not set forth the use of funds under a balanced or surplus budget as well as optimal rate of public debt having no effect on the sustainability of public sector finances.

The Ministry of Finance in general ensures the management of main state debt risks: such risks as refunding, currency, and interest rates are at acceptable level. Since 2003 the Government does not provide new state guaranties for liabilities thus reducing credit risk. Borrowing limits set forth in the Description of the Government of the Republic of Lithuania Medium-Term Borrowing Policy Guidelines are not exceeded; their implementation is under control on the basis of both actual amounts and forecasts. However neither regulations, nor reports on public debt prepared by the Ministry of Finance define and demonstrate sufficiently clearly public debt risks, acceptable and tolerable levels of each risk as well as measures to ensure efficient management of risks identified. In addition, the Ministry of Finance:

¹ Description of the Government of the Republic of Lithuania Medium-Term Borrowing Policy Guidelines approved by the Government of the Republic of Lithuania Resolution No. 602 of 1 June 2005.

- ▶ does not apply the stochastic simulation method based on the cost at risk approach despite the fact that such method was planned to be applied since 2004;
- ▶ does not perform public debt stress tests for modelling economical and financial shocks potentially dangerous to public finance, recommended by the Guidelines for Public Debt Management developed by the International Monetary Fund and World Bank²;
- ▶ does not disclose and assess the effect of contingent liabilities and fiscal threats on public debt management.

The public funds management conducted by the Ministry of Finance needs to be improved. There is no procedure regulating public money management, forecasting and accountability, therefore there is a risk that cash flows forecasts, management, and internal control (as well as estimation of borrowing needs and investment of temporarily free money) will not be reliable, appropriate, and effective. The Commission for Making Decisions on Borrowing on Behalf of the Government, Buying Services Related to Borrowing on Behalf of the Government and Management of Liabilities Undertaken when Borrowing formed by the Ministry of Finance could not make a decision on the 2006 Government Borrowing Programme (borrowing needs for 2006) or its significant amendments.

When forecasting borrowing needs for 2006 the Ministry of Finance did not use the right delegated by the Government to use temporarily free (returnable) money of public funds (Reserve (Stabilisation) Fund).

In 2006 the Ministry of Finance invested free monetary funds only into time deposits of the Bank of Lithuania i.e. temporarily free public monetary funds are not invested for sufficiently long term.

Public debt and monetary funds management information systems should be improved: public debt and monetary funds management apply a lot of manual work and need additional control procedures, increase error probability, does not provide with timely information. Currently public debt management information system undergoes modernisation process; a new subsystem of State Budget, Accounting, and Payments is installed.

We recommended the Government of the Republic of Lithuania to review on a regular basis the State Strategy of a Medium-term Debt Management by reviewing debt management objectives and

² *Guidelines for Public Debt Management, prepared by the Staffs of the International Monetary Fund and the World Bank, 2003.*

indicators; to consider possibility to make a legal provision of using surplus budget revenues after the public sector achieves a zero balance for reducing of public debt.

Having assessed shortcomings detected by the audit we recommended: to set a procedure regulating public money management, forecasting and accountability; to set more clearly terms of reference of the Commission for Making Decisions on Borrowing on Behalf of the Government, Buying Services Related to Borrowing on Behalf of the Government and Management of Liabilities Undertaken when Borrowing formed by the Ministry of Finance so that this Commission would be able to make decisions concerning indicators of annual borrowing needs and their significant changes. In order to manage state monetary funds better we recommend to make faster investment of temporarily free government assets and to consider possibility of investment to other credit institutions. It is necessary to improve public debt and monetary funds management information system; when developing the system capacities of Information Technologies Management Committee should be used, terms of reference of the System Project Monitoring Committee and IS strategic planning processes further developed.

INTRODUCTION

Public debt³ is the aggregate amount of the obligations assumed, but not discharged yet by the general government sector⁴ entities entitled to borrowing in respect of the repayment to creditors of the funds borrowed under government securities which were distributed, including loan agreements, leasing (financial lease) agreements signed and other debt instruments.

According to the Law on Public Debt government securities are issued, money on behalf of government is borrowed, government guarantees are provided and liabilities under other loan agreements are undertaken by the Government. When borrowing and managing debt the Government shall be represented by the Ministry of Finance.

More than 95 per cent of public debt consists of funds borrowed on behalf of government, i.e. funds borrowed by the Ministry of Finance representing the Government under the procedure set by the Government; funds received from securities issued loan agreements signed and other debt instruments (the rest 5 per cent consists of local governments and state social security funds liabilities).

The main objective of the public debt management recommended by the Guidelines for Public Debt Management developed by the International Monetary Fund and World Bank is as follows: to ensure that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk.

Each year the NAO submits to the Seimas a conclusion on whether Public Debt Report data are true, complete and accurate however until now it did not assess the efficiency of the government debt management strategy and monetary funds (including borrowed money) management.

³ The Law on National Debt No. I-1508 of August 22, 1996.

⁴ The sector covers funds of central government (the Government and other institutions attached to the sector) and state social security funds (State Social Insurance Fund, Compulsory Health Insurance Fund, and other institutions attached to the sector).

AUDIT SCOPE AND PROCESS

Auditee – Ministry of Finance of the Republic of Lithuania, code 288601650.

Audit subject – Debt management on behalf of government, programme “Debt Management on Behalf of Government” implemented by the Ministry of Finance.

Audit objective – To assess the debt management on behalf of government (debt management strategy, estimating borrowing needs, management of government funds) and design and objectives implementation of the programme “Debt Management on Behalf of Government” implemented by the Ministry of Finance.

Assessment Criteria:

Data and information collected during this audit will be assessed in the following aspects:

1. Following the legal acts regulating government’s debt management, design, monitoring, and implementation of the programme “Debt Management on Behalf of Government”.
2. Following the Guidelines for Public Debt Management developed by the International Monetary Fund and World Bank.
3. Efficiency of planned government’s debt management measures: comparison of measures applied in Lithuania with good foreign practice.

For more details on audit scope and process as well as definitions of used terms see Annex I of the report.

AUDIT RESULTS

1. Public debt: definition, structure, and trends

1.1. Trends of Macroeconomic Indicators of Debt and Debt Management Expenses

In 2006 Lithuania's economy remained one of the fastest growing economies in the European Union (EU). According to preliminary data in 2006 country's GDP reached LTL 81 991.4 million. In comparison with 2005 it grew by 7.5 per cent. Trends of rates between public debt and other macroeconomic indicators during 2000–2006 period are provided in Table 1.

Table 1. Macroeconomic, debt, and debt management costs trends in 2000–2006, per cent

Year	Public debt / GDP	Changes of state budget revenue	Actual GDP growth	Changes of debt management expenses
2000	28.3	-2.1	4.1	26.9
2001	26.7	9.8	6.6	12.5
2002	26.0	8.1	6.9	-0.3
2003	21.2	40.3	10.3	-15.9
2004	19.4	22.5	7.3	-21.7
2005	18.6	20.0	7.6	-11.8
2006	18.2*	18.7	7.5*	-42.6**

*GDP – preliminary data; **Actual implementation is lower because of “bonus” received and accumulated interests for Eurobonds emissions of 400 and 600 MEUR; *more details in chapter 2.5. of the report.*

Source: Ministry of finance, Department of Statistics under the Government of the Republic of Lithuania.

According to the EU statistics agency Eurostat in 2006 the government sector debt to GDP ratio was higher than 63 per cent in 10 EU member state (Austria, France, Cyprus, Hungary, Malta, Germany, Belgium, Greece, and Italy), and the lowest was in Estonia (4.1 per cent), Luxemburg (6.8 per cent), Latvia (10.0 per cent), Rumania (12.4 per cent), and Lithuania (18.2 per cent) (see Table 2).

Table 2. Trends of government sector debt to GDP ratio in Baltics and EU member states in 2002–2006, per cent

Country	2002	2003	2004	2005	2006
Estonia	5,3	5,3	4,9	4,8	4,1
Latvia	14,4	14,4	14,3	11,9	10,0
Lithuania	22,4	21,2	19,4	18,6	18,2
EU member states (average)	61,7	63,3	63,8	63,4	61,7

Source: EU statistics agency Eurostat

After the restoration of independence Lithuania as Estonia and Latvia did not overtake any domestic or foreign liabilities of the former Soviet Union and since 1991 started independent borrowing policy. However in comparison with Estonia and Latvia during this period the public debt has grown to 18 percent, which is two times higher than in Latvia and four times higher than in Estonia. More details about public debt management strategy see chapters 2.2 and 2.3 of the report.

During the few last years in Lithuania the public debt to GDP ratio was decreasing. Lithuanian public debt to GDP ratio is much lower than the criterion set by Maastricht Treaty (public sector debt should not exceed 60 per cent of GDP or otherwise it should rapidly decrease) and is one of the lowest among EU member states.

1.2. Structure of public debt

By the end of 2006 the public debt equalled LTL 14 938.7 million including: central government debt LTL 14 236 million, local governments LTL 655.2 million and social security funds LTL 47.5 million. Consolidated liabilities among institutions (liabilities among institutions of government sector) were LTL 175.4 million.

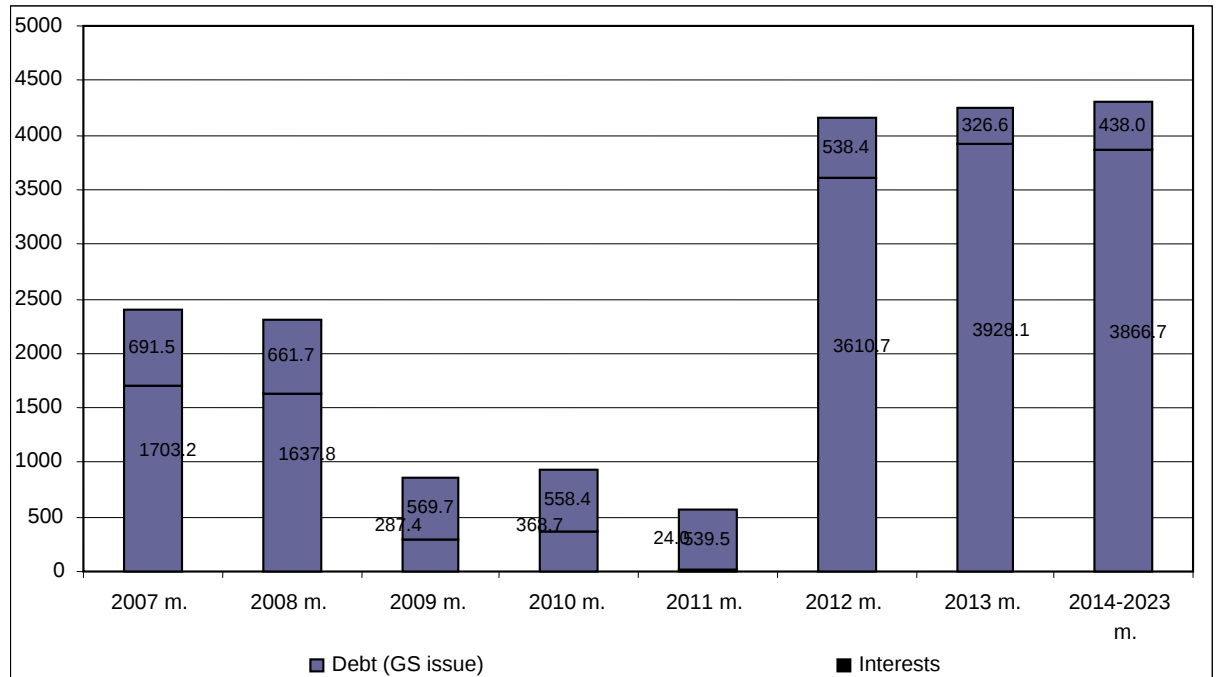
Government domestic debt (liabilities to domestic creditors) by the end of 2006 was LTL 4 719.9 million, what makes 31.6 per cent of public debt. Government foreign debt (liabilities to foreign creditors) by the end of the year was LTL 10 218.7 million or 68.4 per cent of public debt.

Long-term liabilities (more than 1 year) in 2006 grew up to LTL 2 729.6 million and made 97.7 per cent of total public debt while short-term liabilities made 2.3 per cent (LTL 345.9 million).

The amount of outstanding liabilities by December 31, 2006 comprised 9.1 per cent of total debt or LTL 1 361.3 million, while the face value of securities issued increased during the year by LTL 2 111.5 million and by the end of the year reached LTL 13 577.4 million or 90.9 percent⁵.

By May 31, 2007 the total debt of the central government sector for liabilities undertaken under the Law on National debt is about LTL 19 750 million (including LTL 15 427 million for debt repayment and LTL 4 324 million for public debt). This debt repayment is scheduled until 2023 (Fig 1).

⁵ For details see the overview prepared by the Ministry of Finance "Public debt 2006" and Report on 2006 Budget Execution.

Fig. 1 Liabilities of the central government sector LTL million in 2007–2023

Source: Ministry of Finance

Summarising the above information it is clear that long-term foreign liabilities dominate in the government debt portfolio and the majority of them are securities (Eurobonds). Such debt structure is in line with International Monetary Fund and World Bank Guidelines and their risk is acceptable. Reasonable debt structure enables the government to mitigate the impact of interest rates, currency rates, and other risks. (More details on debt risk management see in chapters 2.4 and 2.5 of the report).

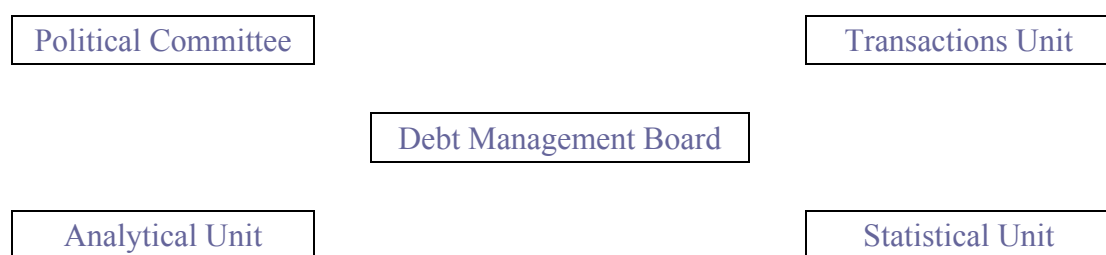
2. Public debt management strategy

2.1. Debt management institutional structure

Two public debt management and administration models are dominating in the world practice: Ministry of Finance of Treasury (Lithuania, Bulgaria, Latvia, Norway); Debt and/or government monetary resource management agency (UK, Austria, Ireland, Portugal, Germany, Netherlands).

It is important that in order to reduce operational risk the debt management should be concentrated in one institution or structural unit and the following public debt management institutional framework (Fig. 2) followed.

Fig. 2 Structural model of a debt management service

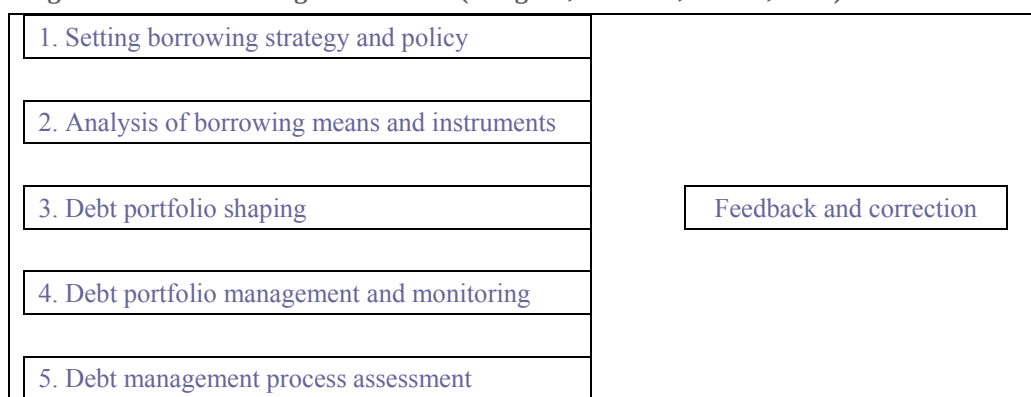


Source: Buškevičiūtė E. Viešieji finansai. – K.: Technologija, 2006

In Lithuania public debt management, administration, and accounting are concentrated in one institution (Ministry of Finance) and this reduces operational risk: since 1998 these functions were fulfilled by the Public Debt Management Department of the Ministry of Finance, and since May 2004 – State Treasury department. Annex 2 of the report contains a scheme including all institutions related to debt management in Lithuania and their main functions (Seimas, Government, Ministry of Finance, Bank of Lithuania, Borrowing Commission under the Government).

2.2. Debt management strategy: objectives, priorities

Fig. 3 demonstrates the theoretical model of debt management. According to this model at first a reasonable borrowing strategy is to be formed and later it may be adjusted using feedback information.

Fig 3. Public debt management model (Bangura, Kitabire, Powell, 2000)

Source: Buškevičiūtė E. Viešieji finansai. – K.: Technologija, 2006

International Monetary Fund and World Bank Guidelines for Debt Management foresee that efficient debt management and sound debt management policy requires clear definition of debt management strategy including:

- main objectives and priorities;
- debt risk management system and basic principles;
- reasonable, tolerable risk management strategy and policy;
- compatibility of debt management with fiscal and monetary policies;
- debt management institutional framework ensuring transparent accountability and responsibilities of debt managing institutions (staff);
- legal framework;
- staff competence;
- efficiency oriented debt management information system.

The main objective of public debt of the Republic of Lithuania management is set in the 2006 Lithuanian Convergence Programme⁶, the Description of the Government of the Republic of Lithuania Medium-Term Borrowing Policy Guidelines, and Strategic Plan of the Ministry of Finance for 2006–2008⁷ as follows: “to ensure the financing of the State budget expenditures and debt liabilities at the lowest costs and acceptable risk, without exceeding the debt and borrowing limits set, and to meet the requirements raised for the Member States striving for the adoption of the Euro”.

The primary objective is in principal consistent with provisions of International Monetary Fund and World Bank Guidelines for Debt Management and world practice:

⁶ Government Resolution No. 1230 of December 8, 2006.

⁷ Minister of Finance Decree No. 1K -082 of March 2, 2006.

Examples of country debt management primary objective definitions

International Monetary Fund and World Bank Guidelines – to ensure that the government’s financing needs and its payment obligations are met at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk.

United Kingdom (Debt Management Office) – to minimise, over the long term, the costs of meeting the Government’s financing needs, taking into account risk, whilst ensuring that debt management policy is consistent with the aims of monetary policy⁸.

The Description of the Government of the Republic of Lithuania Medium-Term Borrowing Policy Guidelines sets main guidelines for Government medium-term borrowing, which will guide up to December 31, 2008 the Government when borrowing, managing debt liabilities on behalf of the State, issuing securities, and other debt liabilities.

This description also sets forth priorities for debt structure and limits for debt liabilities, which should lead to the reducing of debt management risks (for more details see chapter 2.4 and Annex 3). In order to ensure more effective public debt management and debt risks management the Minister of Finance has approved by his decrees rules of applying financial instruments⁹ and rules of temporarily free state monetary resource management¹⁰. Task and measures of debt management are laid down in the description of the programme “Debt Management on Behalf of Government” implemented by the Ministry of Finance.

⁸ *The UK Debt Management Office – Borrowing on Behalf of Government, National Audit Office of UK, 2007 January.*

⁹ Minister of Finance Decree No. 1K-146 of 04.04.2006.

¹⁰ Minister of Finance Decree No. 1K-49 of 28.02.2001 (amended by No. 1K-408 of 12.12.2006).

Having assessed examples from foreign countries we think that the description of borrowing guidelines should be extended by debt risks and their management definition (see for details chapter 2.4) and the following eligible indicators:

- debt-to-GDP, tax revenue ratio;
- debt management cost to GDP, tax revenue ratio;
- value added by government investments, which are funded from funds borrowed on behalf of State ratio to borrowing costs.

2.3. Influence of public debt on public sector finance fiscal sustainability

Many economists are of the opinion that government borrowing is inevitable and not objectionable phenomenon of economic development and rational borrowing by growing economies make positive impact on economic development. However there is always risk that public debt may become an unbearable load for national budget and restrain for further economic development.

As a rule, governments can borrow at better conditions than ordinary people. If borrowed money is invested effectively in future governments will not have to increase tax burden in order to ensure repayment of debts. The so called “golden” borrowing rule says that money should be borrowed only for such expenses, which will yield future revenues and provide conditions for debt repayment (effective investments). Usually investments into education, healthcare, communication, transport are considered to be such investments. If borrowed money is invested effectively, the level of public debt does not threaten economic stability, policy meets optimistic expectations, and there are no external shocks, economy should develop and ensure that the debt will be repaid in time.

Example

Germany, United Kingdom, Portugal – borrowing policy is based on the “golden” rule – net borrowing shall not exceed investments planned for that year.

In Lithuania borrowing objectives are stipulated in the Law on Public debt:

- to finance the State Budget deficit and to balance the State Treasury cash flows;
- to finance State investments and to increase current assets of enterprises;
- to cover the expenses related to the national debt and to repay the national debt;
- to cover liabilities of state funds and to balance the cash flows of the said funds;
- for other purposes if there is a separate law of the Republic of Lithuania.

Actually the major borrowing needs are for State Budget deficit and debt repayment. E.g. in 2006 government borrowing needs equalled to LTL 5 412.4 million including LTL 80.9 million (1.5 per cent) for investments. Government sector deficit (or surplus) makes significant impact on the amount of public debt and debt to GDP ratio. The government covers expenses that exceed revenue (fiscal deficit) by borrowing lacking amount thus increasing the growth of the public debt. When the government sector achieves a balanced indicator the budget surplus may be used for decreasing the public debt. It is obvious that until government sector in Lithuania is not balanced, and investment expenses are negligible the main needs for borrowing will come from the State Budget deficit.

In long term the covering of budget deficit by borrowed funds means that the government sector is supported more than the private sector. Due to this reason negative phenomena may emerge: private sector is outmarketed, market financial activity is restrained¹¹. In order to avoid such negative phenomena developed countries are looking for more flexible ways of funding budget deficit.

Example

In France buyers of government bonds get certain discounts when investing them into privatised state entities. In such case the State gets additional revenue and investors are encouraged to invest into the public sector.

The 2006 Lithuanian Convergence Programme foresees the decrease of the government sector deficit so that in 2008 it will not exceed 0.5 per cent of the GDP, and in 2009 a non-deficit State Budget is planned (Table 3).

Table 3. Government Sector Debt (per cent of GDP) 2005–2009

Year	2005	2006	2007	2008	2009
Indicator	18,7	18,4	19,2	19,0	17,7

Source: 2006 Convergence Programme

European Commission having assessed information on pension, education, healthcare, and other structural reforms provided in 2006 Stability and Convergence programmes and debt situation allocated Lithuania at the low risk countries group from the point of view of the long-term public finance sustainability (Table 4).

Table 4. Public Finance Sustainability Risk

Risk level	Country
Low	Lithuania, Denmark, Estonia, Latvia, Netherlands, Finland, Sweden, Poland
Medium	Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Malta, Slovakia, United Kingdom
High	Greece, Cyprus, Hungary, Slovenia, Portugal

Source: Ministry of Finance. Information to the Government “On Economical Situation” of April 2, 2007

¹¹ Buškevičiūtė E. Viešieji finansai. – K.: Technologija, 2006.

European Commission assesses positively the development of Lithuanian Economy however underlines that since 2008 it may be difficult to achieve planned goals¹².

Note

When assessing 2006 Lithuanian Convergence Programme the European Commission¹³ noticed that current public debt in Lithuania is very low. The improvement of budget situation as foreseen in the above programme should effect the risk management and ensuring the long-term public finance stability.

European Commission underlined that capital investments should be directed to sectors, which may influence the growth of productivity. However during few previous years direct foreign investments remain at a relatively low level if compared with neighbouring countries. In order to avoid a significant increase of public debt the saving should remain at the adequate level. In this context and taking into account the lack of independent monetary policy the fiscal policy should play the increasing role in order to keep a sustainable level of foreign debt for a medium term and to prevent economy from overheating; fiscal consolidation should also be a goal.

European Commission has noticed that the overall assessment could be as said only having in mind the perspective of strong economy growth and in case that medium term objectives foreseen in the convergence programme will be achieved. However there is a risk that since 2008 budgetary objectives may not be met; the programme is not sufficiently ambitious, measures are not clear enough, they do not ensure a long-term fiscal stability.

A kind of warning was the fact that on May 23, 2007 the international rating agency Standard & Poors reduced the borrowing rating perspective from neutral to negative. If no measures concerning the fiscal discipline were taken the borrowing rating may be reduced again.

European Commission in its recommendations of July 12, 2005 on member states and Communities common economic policy guidelines (for 2005–2008) suggests the reduction of public debt as one of measures for strengthening public finances taking into consideration future expenses related to population aging. Taking into account these recommendations Lithuania should strive that public debt would not increase.

Many foreign and Lithuanian analytics agree that it is necessary to define an optimal debt level, which will not endanger fiscal sustainability.¹⁴ Optimal public debt level differs from country to country and it may vary as time goes by. Setting of this level is an empirical research exercise. EU member states according to requirements of the European Union Stability and Growth Pact¹⁵ should follow the Maastricht public debt level criterion (public debt shall not exceed 60 per cent of GDP). However some countries when setting long-term state borrowing strategies assessed their

¹² *Economic assessment of the Convergence Programme of Lithuania (Update of December 2006)* Brussels, 27 February 2007, ECFIN G3 (2007) REP50888-EN.

¹³ *Economic assessment of the Convergence Programme of Lithuania (Update of December 2006)*, European Commission, Brussels, 27 February 2007.

¹⁴ One of definitions of fiscal sustainability/acceptability is the following: such fiscal policies, which decisions do not increase the public debt share in GDP and ensures its stability in accordance to a reasonable growth of economic, interest rates, and inflation.

Source: Training centre of the Ministry of Finance. Training material. Fiscal accounts. Web site: <http://www.fmme.lt/lit/world/paskaita3-10.htm>

¹⁵ *European Union Stability and Growth Pact*, 1997.

economic situation and set forth the optimal public debt level, beyond which the public sector economic sustainability may be at danger:

Example

Finland – by 2010 the debt shall be reduced by 35 per cent of GDP;

Canada – by 2012–2013 the debt shall be reduced by 25 per cent of GDP;

Ukraine – in 2006 The Government set forth a limit that public debt shall not exceed 20 per cent of GDP.

Although the debt reduction is planned in provisions concerning borrowing aims of the Law on Public Debt and documents on fiscal policy development these legal acts do not foresee the use of government funds under the balanced or surplus budget, optimal debt level, which has no influence on public sector finance fiscal sustainability.

2.4. Debt risks management

One of the main public debt management strategy aims is to develop a reasonable, prudent risk management strategy and policy. Debt managers have to monitor and manage financial and operational risks.

International Monetary Fund and World Bank Guidelines for Public Debt Management recommend to debt managers to define, assess and duly manage market, credit, operational risks, risks related to foreign currency and short term debts, changing interest rates, influence on debt stability and sustainability made by indirect and other possible liabilities.

1. *Market risk*

Identification and management of market risk covers the analysis of revenue and other cash flows accessible to government when managing public debt and facilitates the choice of liability portfolio, which meets the above features in the best way.

Many countries strive to retain due public debt structures forecasting if possible, portfolio benchmarks taking into consideration chosen currency, terms of liabilities and maturity dates of securities, etc. This is made in order to have opportunity of adequate forecast of debt portfolio structures in future¹⁶. Debt structure strategic guidelines enabling forecasting and setting forth the probable, comparable debt structure based on advantages of expected expenses and risks may become efficient debt management instruments. Making borrowing decisions debt managers should seek to shape actual structure of debt as close as possible to strategic objectives (guidelines).

¹⁶ International Monetary Fund and the World Bank „Guidelines for Public Debt Management“.

Example¹⁷

In Latvia in 2005 new debt portfolio analysis models were introduced:

- *Budget-at-risk* model, which is used by debt managers for assessing according to different scenarios government borrowing expenses and risks and assessing of debt management expenses debt sensitivity to deviation of exchange rates;
- *Cost-at-risk* analytical model allowing to choose the most appropriate borrowing strategy.

In Latvia SAI point of view at the end of 2005 these models were successfully applied for substantiating the 2006-2008 borrowing strategy.

Already since 2004 the Ministry of Finance provides information that it is going to apply right soon the stochastic simulation method based on cost at risk approach and enabling not only to assess average debt management costs, but also related risks that is the maximum deviation from average public debt management costs with certain probability. The model will also be used for benchmarking the debt structure. In our opinion, this model should be applied as soon as possible in order to manage the debt more efficiently.

The Ministry of Finance explains that it applies the deterministic debt portfolio simulation model enabling to assess debt portfolio settings at different currency rates, interest rates, borrowing needs scenarios. The debt portfolio is shaped setting what instruments, for what currencies and interest rates and for what term will be borrowed during the examined period. Portfolio sensitiveness for external factors is measured using probabilistic, pessimistic, and optimistic scenarios for currency rates, interest rates, risk additives, and borrowing needs changes and market risk management models.

Note

During the audit we did not receive clear prove that this model was applied when forecasting the 2006 borrowing needs.

In order to assess risks the IMF and World Bank Guidelines recommend debt managers to execute debt structure stress test on a regular basis modelling economical and financial shocks, against which the state is potentially insecure. Such assessment is usually performed using financial models: from models based on simple scenario to complex model applying modern statistical and simulation technologies. It is possible to model economy recession and to examine debt trends for certain period. Market risk is identified after assessment of probable increase of debt management costs due to changes of currency and interests rates. It is also necessary to consider potential economical losses due to increased costs or examined situation when the state is unable to refund its debts.

¹⁷ State Audit Office of Latvia, Country Paper "Management, Accountability and Audit of Public debt".

Note

The above stress tests might be performed, for example, after the situation in Latvia has changed at the beginning of 2007 and doubts were raised about the stability of national currency; when rating agency Standart & Poor's reduced Latvia's borrowing ratings, and Lithuania's borrowing rating perspectives were reduced.

It is worth to notice that in Lithuania commercial banks periodically when necessary (when economic situation requires) perform the above stress tests following recommendations and applying models recommended by the Bank of Lithuania.

Currently these tests are not performed for Lithuanian debt management.

As the Ministry of Finance explained, tests are not available because of lacking capacity of information system. It is planned to perform stress tests after the public debt and cash flows management information system will be improved.

2. *Interest rate and exchange rates risks*

▪ *Interest rate risk*

IMF and World Bank Guidelines recommend managing the interest rate risk. The more fluctuating is the interest rate the more borrowing under fixed interest rate is attractive in comparison to borrowing under floating interest rate. Usually it is considered that borrowing under floating interest rate is cheaper in a long term prospective. However countries, which used this opportunity, could not avoid the crisis after interest rates have increased in world markets. Borrowing under floating interest rate is also avoided because it is more difficult to manage cash flows as debt management costs become hardly predictable.

In 2006 in Lithuania government borrowed only under fixed interest rate thus ensuring minimal interest rate risk. At the end of 2006 debt liabilities on behalf of government under floating interest rate made 1.9 percent of all liabilities on behalf of government (for more details see chapter 2.5).

▪ *Exchange rate risk*

The influence of exchange rates fluctuations on debt management costs shall be assessed when managing debt. The Description of the Government of the Republic of Lithuania Medium-Term Borrowing Policy Guidelines foresees that Government borrowing needs will be funded by Litas and Euro or other currency, which will be changed to Litas or Euro applying derivatives. Debt liabilities in those foreign currencies, which may cause undesirable debt management costs fluctuations, shall be reduced.

In 2006 in Lithuania borrowing was carried out only in Litas and Euro. By the end of 2006 the debt in Litas and Euro made 98.8 per cent including 81 per cent in Euro and 17.8 per cent 17.8 per cent in Litas (at the end of 2005 – 98 per cent (69.5 per cent in Euro and 28.5 per cent in Litas). In 2006 managing exchange rate risk Lithuania returned in advance LTL 25 million debts in USD.

Domination in debt portfolio of borrowing in Euro is positive fact as currently Euro is a Litas reference currency and borrowing in Euro enables to avoid currency rates fluctuation risk. There are such marks of debt management improvement are possibilities to use derivatives and other measures mitigating risks.

Worth to notice, that Minister of Finance approved by his decree rules of applying measures for management of temporarily free state monetary funds and liabilities undertaken on behalf of the State by issuing Government securities, signing debt agreements and other binding debt documents however until now derivatives were not used for debt management.

3. *Risk of short term debt liabilities (refunding)*

The Sudden jump of short term debt¹⁸ is considered to be one of reasons of financial crisis, which shocked international markets during the last decade of the XX century. In 1997 almost 60 per cent of developing countries (including Brazil, Korea, Mexico, Russia, Thailand) liabilities to foreign banks were short term.

Big share of short term debt is considered to by a risk factor as during economic instability emerge refunding problems. In case of disorder in financial markets short term is the form of capital, which leaves the country at the earliest because this does not require much effort from creditors.

Lithuania orients towards long-term borrowing, which enables to reduce both refunding and interest rate fluctuation risks. For some time the government ensures short term funds need by issuing securities in domestic market; and this is a sign of sound debt management.

During recent years the share of short-term liabilities on behalf of government constantly decreased and by the end of 2006 made 6.36 per cent of the whole debt (for more details see chapter 2.5 of the report).

4. *Risk of miscellaneous liabilities*

One of factors potentially threatening public finance is indirect state liabilities, i.e. loans with state guarantees. When managing this loan portfolio the Government faces credit risk if debtor who received state guarantee is not able to fulfil his commitments under the contract and financial burden will lay on the Government. Taking into consideration risk of indirect liabilities debt managers must allocate in each year budget respectful appropriations (deferments), which may be necessary in case indirect loans receivers become insolvent.

¹⁸ Short term liabilities are all liabilities with residual maturity of less than one year.

Since 2003 Lithuanian Government does not provide state guarantees for new liabilities thus reducing the credit risk. The Ministry of Finance assesses deferments for debt liabilities, which may arise if government will have to overtake liabilities under state guarantees; information on assessed deferments is submitted alongside with the draft of Law on Approvement of Financial Indicators of State and Municipal Budgets for respectful year.

Indirect public debt risk may arise from miscellaneous liabilities, which in case they rise in future may threaten the fiscal sustainability of public finance. IMF requires disclosing in time information on public finance, fiscal policy objectives, macroeconomical system, budgetary policy, main fiscal threats, and miscellaneous liabilities¹⁹. The disclosure of miscellaneous liabilities is also required by International Public Sector Accounting Standards (standard 19).

In 2006 the Ministry of Finance in the explanatory note to the report on State Budget Execution provides information on liabilities, which are not included in state debt (LTL 1 945.9 million): compensations for immovable property bought out by the State (LTL 744.7 million); discount loans for building or buying houses, apartments to citizens having right to receive state aid (LTL 59.1 million); restoration of people savings (LTL 1 142.1 million).

However it is not clear how much public money may be required for example for Ignalina nuclear power plant closing; fulfilment of liabilities rising from suits against the State; pension system and other reforms. Lithuanian economy is transformed during more than a decade. Public debt managers should consider also potential money need for ongoing infrastructure, healthcare, labour market, public administration, local governments and other reforms. Accidental economic events such as political and economical situation in domestic and foreign markets, oil prices fluctuations, i.e. all factors, which may unexpectedly affect the economic development and public finance, should also be not ignored

Currently the Ministry of Finance discloses and assesses miscellaneous liabilities insufficiently. Already since 2002 NAO recommends to the Ministry of Finance to disclose miscellaneous liabilities and potential fiscal threats and assess them when managing public debt²⁰.

Worth to notice, that taking into account provisions of Public Sector Accounting Reform these liabilities shall be disclosed in consolidated state accounts since 2012. In 2005 the 18 standard of public sector accounting financial statements "Extended debts, miscellaneous liabilities, undefined assets, and events after accounting period" was drafted.

¹⁹ International Monetary Fond „The Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles“.

²⁰ NAO conclusions on Public Debt Accounts for 2002–2005.

Example²¹

The US public was shocked in 2006 by numbers that were published after the state consolidated accounts were made for the first time on the basis of International Accounting Standards so that expenses were disclosed at the moment of their origin and all potential state liabilities were assessed.

It was announced that each US household will have to pay each year more than USD 31 thousand during 75 years in order to cover indirect state liabilities (unfunded promises concerning State Medical Service, Social Security and Pension Programmes).

5. Operational risk

Debt managers face operational risk as borrowing in domestic and foreign markets as well as managing the public debt portfolio. This type of risk covers wide range of different elements – it is risk of human errors related to accounting and performing of borrowing and paying transactions (human factor); risk of absence of proper internal control mechanisms or poor their management (functioning); reputation and legal risk; risk of absence of security measures or their management, etc.

According to IMF and World Bank Guidelines public debt management requires knowledge of financial markets (first of all portfolio management and risk analysis) and state policy. Despite of the institution structure ability to attract and retain competent staff is crucial for mitigating operational risk. Investment into training may help solving problems however there is a big difference of remuneration in public and private sectors therefore public debt managers face the difficulties in retaining competent specialists.

As the whole public sector in Lithuania, the Ministry of Finance faces the staff turnover problem and difficulties in retaining competent specialists. Private sector (for example commercial banks) is able to offer to debt management experts much higher salaries than those in public sector. The Ministry of Finance pays much attention to staff training. Each year specialists of the Treasury Department responsible for debt management participate in seminars and training in foreign countries.

Summarising the management of all risks it is worth underlining that the propriety of debt strategy depends on how the government tolerates risks. The Ministry of Finance in general ensures the debt risk management and when borrowing follows priorities and limits set forth in the Description of the Government of the Republic of Lithuania Medium-Term Borrowing Policy Guidelines (for more details on following borrowing limits in 2006 see chapter 2.5 of the report).

²¹ Rules “hiding” trillions in debt – liability \$516 348 per U.S. household, by D. Cauchon, USA Today newspaper.

However it is worth noticing that legal acts of the Republic of Lithuania do not contain clearly defined and identified notion of risk potentially threatening public debt structure, the tolerable, acceptable risk level is not named as well as long-term measures, which could ensure efficient management of identified risks. All these aspect should be reflected in the public debt management strategy.

2.5. Borrowing limits set forth by the Government

The Description of the Government of the Republic of Lithuania Medium-Term Borrowing Policy Guidelines set forth limits that should be followed when implementing the Government medium-term borrowing policy.

These borrowing limits are set conservatively and managing refunding, interest rate fluctuation, and financial risks as well as having assessed the results of simulation calculations. According to simulation calculations the overrun of these limits will be a serious signal to public finances. In addition, limits overrun may induce rating agencies to review Lithuanian ratings. In case it would be decided to reduce ratings the borrowing costs would grow.

Following of borrowing limits in 2006:

- Short-term debt liabilities should not exceed 30 per cent of all debt liabilities on behalf of government.

Actual value of this indicator in 2006 was 6.36 per cent. Short-term liabilities for government securities were LTL 864 619 thousand and loans LTL 40 197.68 thousand (in total LTL 904 816.68 thousand), at December 31, 2006 debt liabilities on behalf of government were LTL 14 235 972 thousand. The limit was not exceeded (Table 5).

Table 5. The dynamics of the ratio of short-term liabilities and all debt liabilities on behalf of government (per cent)

Year	2005	2006
Maximal amount set forth by the Government decree	30	30
Actual	18,7	6,36

Source: Ministry of Finance

- Interest expenditure for debts on behalf of government, securities issued, and other debt liabilities on behalf of government shall not exceed 10 per cent of the annual amount of tax revenue planned to be collected to the State Budget. This indicator shows what share of collected taxes the Government can use for paying interest expenditure for debts on behalf of government, securities issued, and other debt liabilities on behalf of government.

Actual value of the indicator in 2006 was 2.39 per cent. According to data of the State Budget Execution Report it was collected LTL 13 244 536.7 thousand of taxes, and expenditure for interests in 2006 were LTL 316 913.72 thousand. The limit was not exceeded (Table 6).

Expenditure for interest totalled LTL 316 913.7 thousand. Having in mind that it was received a LTL 244 165 thousand bonus and accumulated interest of MEUR 400 for bonds issued in February 2006 and MEUR 600 for bonds issued in November 2006 expenditure for interest would be more by 43.5 per cent (LTL 316 913.7 thousand + LTL 244 165 thousand = LTL 561 078.7 thousand). If expenditure for interest would not be reduced by Bonus and accumulated interest amounts, the actual value would make not 2.39 per cent but 4.49 per cent.

Table 6. The dynamics of Interest expenditure for debts on behalf of government, securities issued, and other debt liabilities on behalf of government and annual amount of tax revenue planned to be collected to the State Budget ratio (per cent)

Year	2004. ²²	2005	2006
Maximal amount set forth by the Government decree	15	10	10
Actual	5,1	4,9	2,39

Source: Ministry of Finance

- Debt liabilities on behalf of government under floating interest rate shall not exceed 25 per cent of all debt liabilities on behalf of government.

Actual value of this indicator in 2006 was 1.88 per cent. Debt liabilities on behalf of government under floating interest rate by the end of 2006 were LTL 266 889.6 thousand, and total amount of debt liabilities on behalf of government was LTL 14 235 972 thousand. The limit was not exceeded (Table 7). In Annex 4 of the report we provide a comparison of Lithuanian borrowing limits with those of Latvia and Canada.

Table 7. Trends of ratio of debt liabilities on behalf of government under floating interest rate to all debt liabilities on behalf of government (per cent)

Year	2004. ²³	2005	2006
Maximal amount set forth by the Government decree	30	25	25
Actual	6,5	6,1	1,88

Source: Ministry of Finance

Limits set for 2006 in the Description of the Government of the Republic of Lithuania Medium-Term Borrowing Policy Guidelines were not exceeded. Refunding, currency rate fluctuation, and interest rate risks are acceptable. Currently the meeting of limits set forth in legal acts is under control on the basis of both actual amounts of liabilities and their forecasts.

²² In 2004 another indicator was applied: interest expenditure to State Budget revenue.

²³ Until 2004 different value of this indicator was set forth.

3. Programme “Public Debt Management” implemented by the Ministry of Finance in 2006

3.1. Implementation of measures of the programme “Public Debt Management”

Ministry of Finance seeking to manage public debt efficiently implements the programme “Public Debt Management” (Programme). Responsible unit is the Treasury Department of the “Ministry of Finance”. The programme is continuous, it is implemented since 1999.

The goal of the programme is as follows: to ensure the funding of government borrowing and to improve the management of the public debt (Table 8).

Table 8. Objectives and measures for their implementation foreseen in the 2006 programme

Objectives	Implementation measures
1. To seek to fund government borrowing in a timely manner at the least cost and with acceptable risk without exceeding debt and borrowing limits	1.1. Paying interest for public debt to domestic and foreign creditors; 1.2. Implementation of measures related to public debt management (settling off with creditors of failed entities or those facing problems); 1.3. Planning of public debt management expenditure, forecasting and setting limits of public debt and government borrowing needs, accumulation of necessary financial resources, efficient investment of temporarily free borrowed funds.
2. To ensure efficient debt liabilities management and administration.	2.1. More efficient debt recovery and application of measures ensuring the fulfilment of debt liabilities; 2.2. Improvement of public debt and government monetary resources management information system; 2.3. Public debt risks management; 2.4. Preparing and publishing information and accounts on debt to the public, investors, and international organisations.

Source: Description of the programme “Public Debt Management” implemented by the Ministry of Finance

In order to achieve the above goal in 2006 were designed two objectives (see Table 8). The same objectives are planned for the 2007 programme. In opinion of public auditors those objectives are relevant for implementing the programme goal.

Point 41 of the Strategic Planning Methodology²⁴ stipulates that measures for implementing objectives should be the most efficient and reasonable way for achieving the desired result. It is recommended to foresee more than one measure and to rate them by priority.

²⁴Approved by the Government Resolution No. 827 of June 6, 2002.

Measures for programme implementation do reflect terms of reference of the Treasury Department and its structural units as well as daily functions implemented managing public debt and administrating debt liabilities (settling off with creditors, payment of debt and interests, preparation and publication of information on public debt, etc.). In our opinion the measures are not specific, too abstract however their implementation enables to implement the programme objectives.

Foreign practice demonstrates that when implementing a medium-term (2–3 years) debt management strategy more specific measures may be foreseen enabling to evaluate achieved results (Table 9).

Table 9. Extract from Canada Ministry of Finance Debt Management Strategy for 2007–2008

Objective – In 2007–2008 gradually decrease the share of debt under fixed interests from 2/3 to 60 per cent of the total amount of the debt.		
Measure	Planned result	Measures and actions implemented under the 2005-2006 Debt Management Strategy
1. Gradually decrease the share of debt under fixed interest down to 60 per cent	Debt management costs will decrease; a prudent budget risk management to be continued	During 2005-2006 period the share of debt under fixed interest came down from 63.1 to 62.5 per cent
2. To increase the share of treasury bonds programme from USD 130 billion in 2004-2005 to USD 140 billion in 005-2006		The outcome was not achieved therefore the measure shall be continued. The treasury bond share increased by USD 4.4 billion (from USD 127.2 billion to 131.6) because the funding sources exceeded the planned
3. To issue in 2005-2006 bonds for USD 33 billion that is by USD 3 billion less than in 2004-2005. Taking into consideration long maturity terms and continuation of redemption transactions it is expected to reduce the amount of bonds by USD 8 billion down to USD 235 billion.	To adjust market with bond and treasury bill programmes	The value of bonds issued was USD 32.4 billion. The share of bonds issued decreased by USD6.9 billion (to USD 237.3 billion)
4. To reduce the redemption of regular bonds by a. USD 8-9 billion (by USD 1.5 billion less than in 2004-2005).	To retain the liquidity of bonds issued.	Bonds for USD 8 billion were redeemed implementing the regular bonds redemption programme.
5. To retain stable terms of bonds redemption by adding issues and applying monetary resource management redemption programme (CMBB programme) in order to reduce redemption terms.	To limit the need for redeeming the significant share of the debt in a year	The average redemption term of debt liabilities was retained making a. 6.5 year. Under the CMBB programme redeemed bonds for total amount of USD 8.7 billion. During 2004–2005 and 2005–2006 actions under CMBB programme enabled to reduce in 2005-2006 bond redemption terms by 30 per cent from average.

Note. Debt Management Strategy foresees three objectives, the first of which is laid down in the above table, and the rest two are as follows: to manage various sources of debt funding and well functioning market and to invest more efficiently into foreign reserves.

Source: The website of the Ministry of Finance of Canada <http://www.fin.gc.ca>

In our opinion the accountability for measure implementation should be improved. For example in the report of the Ministry of Finance for 2006:

- There is very poor information on the measure “Efficient Investment of Borrowed Funds”: only that seeking to manage temporarily free government monetary recourses better the Rules of Investment of Temporarily Free government monetary Funds were approved by the decree of the Minister of Finance No. 1K-408 of December 12, 2006;
- What concerns the measure “Ensuring the more Efficient Debt Recovery and Debt Liabilities fulfilment” it is indicated that in 2006 LTL 90 588.91 thousand were collected from debtors (planned LTL 63 433.82 thousand) and LTL 88 551.68 thousand collected of reloaned interest (planned LTL 69 707.16 thousand). Having assessed that more than a half of liabilities to the state were overdue and their reduction may be achieved not by more efficient recovery actions but by write-off of those liabilities²⁵ we have doubts about adequacy of the debt recovery efficiency assessment;
- What concerns the measure “Public Debt risks Management” the information is submitted only on currency rate risk management: in 2006 LTL 84.6 million of loans were repaid. We think that the implementation of this measure should cover also the development of the public debt risk management system (naming risks, information sources, methods of risk level evaluation, list of potential risk mitigating measures, etc).

Providing information to government institutions, public, investors, international organisations is one of functions of the Treasury Department, which if implemented duly should increase the transparency of the Ministry of Finance and improve public information on public debt management.

Having in mind the programme seeks:

- to achieve that Euro denominated securities would form the increasing share of public debt liabilities;
- to develop large and liquid government securities Euro denominated government bond issues to be traded in international electronic government bonds systems;
- to create better opportunities for domestic and foreign investors to acquire government bonds;
- to concentrate at 3.5 and 10 year government bonds emissions at the same time reducing the number of emissions in the domestic market distributed through auctions;
- to increase the share of foreign debt denominated in Euro and use financial insurance instruments,

²⁵ NAOL public audit report “Fulfillment of Financial Liabilities to the State” of December 28, 2005.

There should be foreseen specific measures, which would enable to achieve the above objectives and which would have measurable outcomes.

There should also be foreseen measures related to the development and improvement of legal acts regulating public debt management, staff training, co-operation with other financial institutions (experts).

3.2. Programme evaluation criteria

Objective evaluation criteria indicated in the 2006 Programme Description are enlisted in Table 10.

Table 10. Programme evaluation criteria and their implementation in 2006

Criterion	Implementation of the criterion in 2006
For the outcome: The weighed average of risk premium paid in domestic market for government securities in comparison to German government securities is planned 35 basic points (basic point is one hundredth of per cent)	In 2006 – 21 basic point. Lower weighed average of risk premium paid in domestic market for government securities in comparison to German government securities shows lower than planned government borrowing cost in domestic market
For the objective: number of relatively liquid (LTL 400-600 million) Lithuanian Government securities emissions distributed in domestic market planned 4	2006 – 2 emissions.
For the objective: Number of emissions of the Lithuanian Government securities distributed through auction planned 14.	2006 – 13 emissions.
For the objective: Actual money collection and recovery to amount of planned collection of loaned money ratio in percent planned 100 per cent.	In 2006 it was planned to collect LTL 133.14 million, actually received LTL 175.3 million of loans and interests i.e. by LTL 42 million or 31.7 per cent more.

Source: Ministry of Finance

The Strategic Planning Methodology sets forth that the outcome measurement criterion is the programme objective achievement criterion and it should reflect the use, which is gained by the direct beneficiary in case the objective were achieved. As the objective of the programme is to ensure the funding of the Government borrowing need and to improve the debt on behalf of government management it is clear that the Programme outcome criterion concerns government borrowing costs i.e. only one of public debt management indicators.

Product criteria: number of emission of securities distributed in domestic market and number of emissions distributed through auction does not demonstrate qualitative changes in debt management, and actual implementation depends on various circumstances for example on decrease of borrowing need (better collection of budget revenue), use of better borrowing conditions in foreign markets than in domestic market, etc. This is confirmed by 2006 outcomes: 4 emissions planned, actually implemented 2 emissions however government borrowing need is fully met therefore although the criterion is implemented only by 50 per cent there is no reason to assess performance badly.

Example

Foreign countries practice examples show that the following evaluation criteria could be applied:

- Long-term to short-term debt ratio; foreign to domestic debt ratio; debt with fixed interest rate to floating interest rate ratio;
- Distribution by financial instruments.

In our opinion evaluation criteria do not provide sufficient information on implementation of programme goals and objectives (do not enable to assess use gained by direct and indirect programme beneficiaries).

3.3. Use of 2006 budget appropriations allocated for debt management

LTL 610 604 thousand assigned for 2006 Programme implementation (Table 11).

Table 11. Use of 2006 Programme budgetary appropriations (LTL thousands)

Planned appropriations	Planned	Actually used	Difference
Interests for government debt (Government securities and loans) total:	574826	316913.7	257912.3
Including:			
Non-residents	395310	148085.2	247224.8
residents, other non-government sector	179516	168828.5	10687.5
Expenditure for public debt management	35778	8142.4	27635.6
Including:			
Missions, communications, and other expenditure	92	15.5	76.5
Payments for financial information and financial services provided (payments to hired experts, consultants, payments to the Bank of Lithuania for transactions and currency exchange, commission charges)	4217	2842,3	1374,7
Other services (to financial institutions for safekeeping of government securities, listing, to stock company Turto Bankas for management of government securities emissions, commission payments for distribution of government securities to Central Project Management Agency for loan administration)	7364	2254.1	5109.9
Other expenditure (for other current purposes such as refunding in advance payments, currency rates differences)	24105	3030.5	21074.5
Total	610604	325056.1	285547.9

Source: Ministry of Finance.

Actually in 2006 LTL 325 056.1 thousand were used (53.2 per cent of planned funds or less by LTL 285 547.9 thousand).

Reasons of decrease of funds needed for implementation of the Programme:

- The decrease of interests costs (by LTL 257 912.3 thousand or 44.9 per cent) was mainly caused by received LTL 244 165 thousand premium and accumulated interest for

MEUR 400 Eurobond emission issued in February 2006 and MEUR 600 Eurobond emission issued in November²⁶;

- The decrease of expenditure for interests was partly caused by lower interest rates both in domestic and foreign markets and favourable currency rate fluctuation;
- As the State Budget deficit was lower than planned (by LTL 553 869.4 thousand), government borrowing need decreased.

Actual use of budgetary appropriations for the Programme has trend to decrease (Table 12).

Table 12. Dynamics of planned and used budgetary appropriation for the Programme (LTL thousand)

Budgetary appropriations for the Programme	2003	2004	2005	2006
Planned in the current year budget	976 205	705 361	590 133	610 604
Actually used	820 278	641 942	566 189	325 056

Source: Ministry of Finance

²⁶ For more details see NAO report No. FA-8000-10-48 of May 31, 2007.

4. Borrowing Need and Management of Monetary Resources

4.1. Setting and following the net borrowing limit

According to Article 18 part 2 point 4 of the Law on Budget Structure²⁷ the draft of the Law on Improvement of State Budget and Municipal Budgets Financial Indicators shall set forth a net borrowing limit, which shall be approved by adopting the said law. According to the rules the Government net borrowing amount shall be approved by the Ministry of Finance²⁸ the difference between Government liabilities undertaken during a certain period under debt agreements and government securities sum and the sum of fulfilled or partly fulfilled government liabilities during the same period.

The Government net borrowing limit shall be assessed following the Rules of Assessing the Government Borrowing Need and Planned Borrowing²⁹. Government borrowing need shall be the sum of state expenditure and refunded loans during the budgetary year funded from borrowed on behalf of the state money. The borrowing need consists of funds needed to be borrowed for purposes stipulated in Article 4 of the Law on Public Debt (see Table 13).

According to the Rules of Assessing the Government Borrowing Need the Forecasting and Risk Management Division of the State Treasury Department using information system assesses the amounts borrowed on behalf of the state from domestic and foreign markets as well as amounts of foreign government securities acquired. The borrowing need is also assessed using data from other units of the Ministry:

- ▶ Borrowing and Funds Management Division of the State Treasury Department – on annual amount of funds borrowed on behalf of the state required to fund the Government Investment Programme according to signed agreements;
- ▶ Fiscal Policy Department on the amount of the forecasted State Budget deficit;
- ▶ Budgetary Department on laws and drafted legal acts stipulating the funding of state expenditure from borrowed funds.

²⁷ The Law on Amendment of the Law on Budget Structure No. IX-1946 of December 23, 2003.

²⁸ Approved by the decree of the Minister of Finance No. 1K-210 of June 8, 2007.

²⁹ Decree of the Minister of Finance No. 1K-239 of June 21, 2004.

Rules of Assessing the Government Borrowing Need shall be improved as they do not foresee:

- the form and terms of submitting information to the Forecasting and Risk Management Division;
- that borrowing need assessment shall use cash flows forecasts and which unit shall provide them;
- that Financial Market Department shall submit information on the amounts of extended loans with government guarantee (potential government expenses, which should be taken into account when forecasting next year borrowing need).

Note

According to calculations made by the Financial markets department the amount of extended loans with state guarantee was LTL 31 million in 2006 and LTL 24 million in 2007. These amounts shall be taken into account when forecasting the next year borrowing need. Having assessed the forecasting of borrowing need public auditors did not find evidence that extended loans with state guarantees are included into the forecasted borrowing need. In 2006 when assessing the borrowing need for 2007 the Ministry of Finance included extended loans with state guarantees.

During the public audit we assessed how the net borrowing limit for 2006 was set and assessed. The State Treasury Department sent a letter to the Budget Department³⁰ including suggestions for 2006 amendments of some articles of the Law on Approvement of State Budget and Municipal Budgets Financial Indicators and suggesting to set forth the net government borrowing limit of LTL 1 800 million. At the same time the Government Borrowing Programme for 2006 was introduced where the borrowing need was set forth as LTL 4 209 million (see in Table 13 data for September 8, 2005).

The Government Borrowing Programme contains the summarised information on planned borrowing.

Example

Canada 2007–2008 Debt Management Strategy, which is submitted at the beginning of the fiscal year to the Parliament, contains data on the main strategic accents: debt structure, borrowing plans, detail forecasts of borrowing and use of borrowed funds.

³⁰ Letter No. (13.33-0303)-15K-636 of September 13, 2005 on the Law on Approvement of State Budget and Municipal Budgets Financial Indicators for 2006.

After Seimas has approved the 2006 State Budget³¹ the borrowing need and borrowing amounts were adjusted on December 12, 2005 (see in Table 13 data for December 12, 2005). The adjusted 2006 borrowing need increased by LTL 1 201.6 million, and planned borrowed amount by LTL 1 214 million, planned financial borrowing instruments were changed as well as the short-term to long-term borrowing ratio however all above changes did not affect the approved amount of the net borrowing limit (LTL 4 800 million).

Explanation by the Ministry of Finance

The 2006 borrowing need was planned in December 2005 on the basis of assumptions that differed from those of September 2005. The choice of borrowing instruments increased and planned borrowing instruments were changed. In order to increase the liquidity of government securities it was decided to add to emissions of standard maturity government securities therefore the share of 2006 redeemable domestic government securities increased.

Not planned at the end of 2005 additional expenditure (compensations for immovable property, restoration of savings) and adjusted in 2006 forecasts of cash flows caused the increased use of planned short-term borrowing instruments therefore increased the amount of borrowing instruments which were planned to be redeemed in 2006.

Table 13. Planning of 2006 borrowing need (LTL million)

Planning date:	08.09.2005	12.12.2005	Difference
GOVERNMENT BORROWING NEEDS	4 209.0	5 412.4	1203.4
State Budget deficit	1 747.0	1,747.0	0.0
Investments from borrowed funds	79.1	80.9	1.8
Debt redemption:	2 383.0	3 584.5	1 201.5
Redemption of domestic debt:	1 292.0	1 963.1	671.1
Redemption of government securities:	1 292.0	1 963.1	671.1
Redemption of government securities, floated before the date of assessment	1 027.0	1 315.8	288.8
Redemption of government securities planned for redemption	265.0	647.3	382.3
Redemption of domestic loans	0.0	0.0	0.0
Redemption of foreign loans:	1 090.9	1 621.4	530.5
Redemption of foreign loans:	1 090.9	55.4	-1035.5
Redemption of taken foreign loans	55.1	55.4	0.3
Redemption of foreign credit line	1 035.8	0.0	-1 035.8
Redemption of foreign government securities:	0.0	1 566.0	1 566.0
Redemption of government securities distributed before the date of assessment	0.0	253.9	253.9
Redemption of planned government securities	0.0	1 312.1	1 312.1
PLANNED BORROWING	4 146.0	5 360.0	1 214.0
Domestic government securities	1 650.0	1 550.0	-100
From signed loans for funding investments	79.1	80.9	1.8
Foreign government securities:	1 381.1	3 729.0	2 347.9
Eurobonds	1 381.1	1 381.1	0.0
Eurosecurities	0.0	2 347.9	2 347.9
Credit line	1 035.8	0.0	-1035.8
NET BORROWING	1 763.1	1 775.4*	12.3

*Not include LTL 3 000 million for redemption of stock company Mžeikių nafta shares.

Source: Forecasting and Risk Management Division of the Ministry of Finance

³¹ Law on Approval of State Budget and Municipal Budgets Financial Indicators for 2006 No. X-433 of December 8, 2005.

The actual government borrowing limit for 2006 (LTL 1 546 550.5 thousand) did not exceed the amount set forth in the Law on Approvement of State Budget and Municipal Budgets Financial Indicators (LTL 4 800 000 thousand). Information on borrowed and redeemed amounts by financial instruments is provided in Annex 5 of the report. Such actual amount of the net borrowing limit was caused mainly by:

- avoiding of need to borrow LTL 3 000 million for acquiring shares of the stock company Mažeikių Nafta;
- less than planned state budget deficit;
- other reasons including direct payments to agriculture.

Note

The 2006 Law on Approvement of State Budget and Municipal Budgets Financial Indicators approved the net borrowing limit as LTL 4 800 million (the difference compared with the amount suggested by the Ministry of Finance is LTL 3 000 million). The net borrowing limit was increased by LTL 3 000 million following Article 2 part 3 of the Law on Acquiring and Disposal of Shares of the Stock Company Mažeikių Nafta³², which stipulated that Seimas has decided to buy shares of the stock company Mažeikių Nafta from the Netherland company Yukos International U.K. B.V. by borrowing on behalf of government. The amount borrowed on behalf of government should not exceed LTL 3 000 million. Information on the draft of the above law following the Rules of Assessing the Government Borrowing Need had to be submitted by the Budget Department to the State Treasury Department for forecasting the 2006 borrowing need.

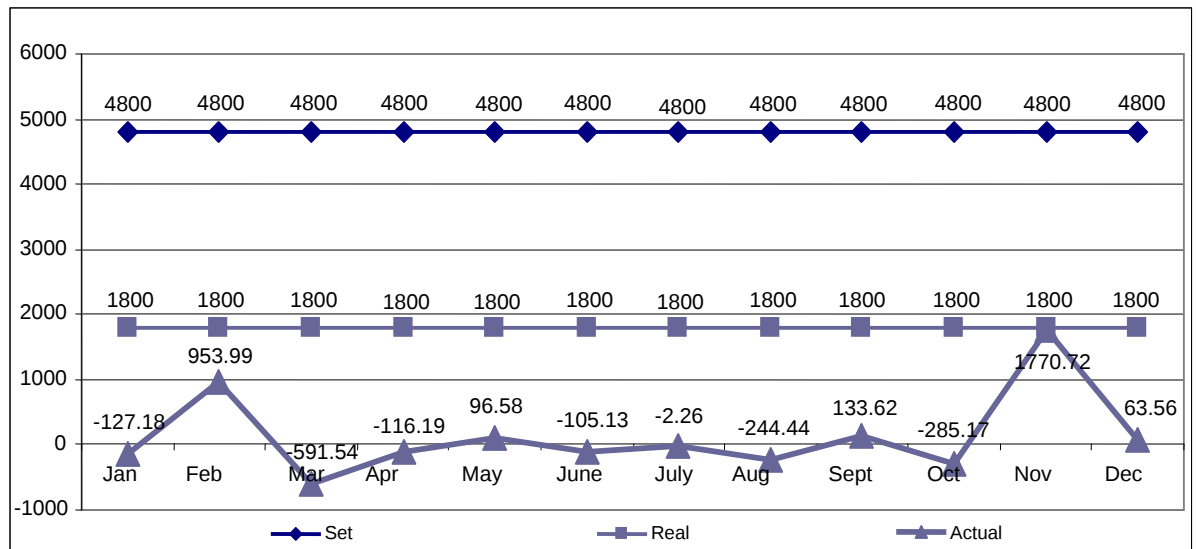
According to the Ministry of Finance the State Budget was drafted before Seimas adopted the Law on Acquiring and Disposal of Shares of the Stock Company Mažeikių Nafta. Having in mind the large amount, which was foreseen in the draft of the Law on Acquiring and Disposal of Shares of the Stock Company Mažeikių Nafta and not confirmed yet including this information into the draft of the Law on Approvement of State Budget and Municipal Budgets Financial Indicators was too risky; however after the law was adopted and allowed to borrow LTL 3000 million this amount was immediately included into the above law draft.

Worth noticing that by 2007 Law on Approvement of State Budget and Municipal Budgets Financial Indicators the net borrowing limit is also increased by LTL 3000 million for the same reason although the bargain and sale contract signed on June 9 included provision that in case the Government of Republic of Lithuania and Polish oil company PKN Orlen S.A. fulfil all contract conditions the deal shall be considered valid since December 15, 2006. **We think that the 2007 net borrowing limit shall be reviewed by revising the above law.**

Fig. 4 demonstrates how the 2006 net borrowing limit was followed (by months); actual situation seems distorted because of the net borrowing limit increase by LTL 3000 million:

³² Law on Acquiring and Disposal of Shares of the Stock Company Mažeikių Nafta No. X-377 of October 20, 2005.

Fig. 4. Following of the net borrowing limit by the Government in 2006 (LTL million)

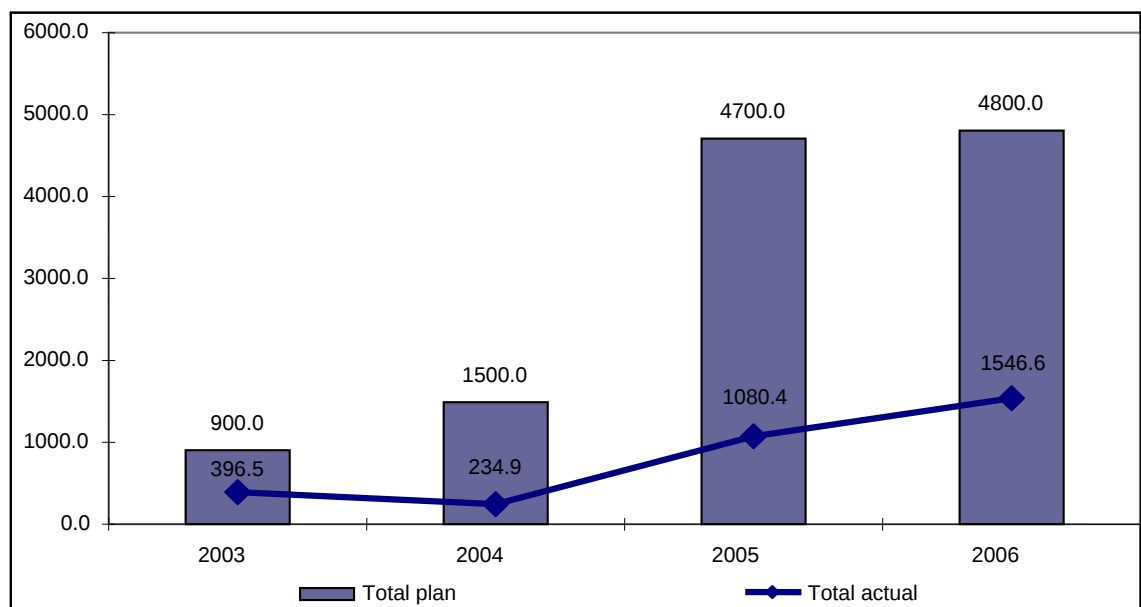


*Real shall be net borrowing limit without LTL 3 000 million foreseen for acquiring Mažeikių nafta shares

Source: Ministry of Finance

When analysing trends of setting and following the net borrowing limit (Fig. 5) we noticed that there is a risk that the net borrowing limit alongside with the annual borrowing need are not assessed with sufficient accuracy (for more details see chapter 4.2. of the report).

Fig. 5. Trends of the net borrowing limit in 2003–2006



Source: Ministry of Finance

The amount of the net borrowing limit, which is included into the draft law on a current year budget for objective reasons, is assessed having no detail forecasts of 2006 monetary resources. Borrowing need is preliminary depending on how much borrowing will be needed for funding the state budget deficit, state investments, and fulfilment of debt liabilities.

4.2. Principles of government borrowing forecasting and management of monetary resources

4.2.1. Forecasting and management of state monetary resources

The borrowing need is assessed on government monetary resources forecasts basis. Efficient public debt management is directly related to the government monetary resource management.

During the audit we found out that the government monetary resources management by the Ministry of Finance should be improved. Government monetary resources are planned following the rules of the State budget and local governments' budgets composition and execution³³ approved by the Government. However there is no approved procedure regulating forecasting, management and accountability of monetary resources.

Examples of shortcomings in government monetary resource management

There is no automatic link between resource flows management and:

- planned borrowing, loan refunding, government securities redemption, and interests payments;
- planned relending contracts;
- receivable relended loans and interests;
- information from the Bank of Lithuania;
- budgetary information;
- information from the stock company Turto Bankas on planned refunding of loans and interests;
- information on investment contracts and revenue from investments;
- information about funding of appropriation managers.

Currently State Treasury accounts: budgetary, European Union, borrowed funds accounts and monetary funds are accounted within different not integrated systems therefore there is no necessary information to manage monetary resources flows efficiently.

The monetary resources flows management does not get all information on planned revenue: DMFAS³⁴ does not record information on loans, which are passed to administrate to the Turto Bankas, for example received payments are not recorded, loan conditions are not renewed if there is a decision to amend them. Therefore the general system does not possess the whole information on loans.

All calculations of monetary resources flows are done with *MS Excel* software are based on manually entered data from other not interlinked system and received from other units of the Ministry of Finance or other institutions.

³³ Government Resolution No. 543 of May, 14, 2001.

³⁴ Public Debt Administrating System.

Until March 2007 information on borrowing need, funding sources, and monetary resources forecasts were submitted to the management of the Ministry of Finance only if needed.

In the absence of the government monetary resources management procedure there is a risk concerning monetary resources flows forecasts, management, and internal control reliability, adequacy, and urgency and at the same time concerning the inseparable from the monetary resources management assessment of borrowing need and investment of temporarily free monetary resources. The above criteria are significantly influenced by the fact that monetary resources are forecasted and managed using *Excel* spreadsheets; part of information on revenue is confirmed by phone, data received not periodically and not from all appropriations managers.

There should be a clearly defined and regulated government monetary resources management: indicating, which structural unit of the Ministry of Finance is responsible for the government monetary resources management, what data sources should be used for forecasting cash flows, who and when should submit data, what data basis should be used, how often information should be renewed, who are information users, what are internal control procedures.

Data from Table 14 show that during the first three quarters of 2006 there was no actual State Budget deficit however LTL 393.1 million were transferred for funding the deficit from borrowed funds. While the most need for borrowed money to fund the State Budget deficit (LTL 1633 million) emerged in the 4th quarter of 2006.

Table 14. Funding of the State Budget deficit in 2006 (LTL million)

	I quarter	II quarter	III quarter	IV quarter	Total
Transferred (+) / recovered (–) from borrowed funds for State Budget funding	+ 286.5	+ 219.1	– 112.5	+ 840.6	+ 1 233.7
Actual State Budget deficit (–) / surplus (+)	+ 228.2	+ 13.7	+ 197.9	– 1 633.0	– 1 193.2

Source: Ministry of Finance

Explanation of the Ministry of Finance

Rules of forecasting monetary resources are currently designed and adjusted with other structural units of the Ministry of Finance.

Information systems used by the State Treasury Department are currently modernised in order to make them appropriate to fulfil public debt and monetary resources management and accounting functions efficiently, accurately, and timely. After the modernisation is finished we hope that *Excel* spreadsheets will not be used so widely.

Since July 1, 2007 comes in force the Minister of Finance decree, which will require all appropriations managers to submit forecasts of appropriation needs via VBAMS³⁵.

On instruction of the State Secretary of the Ministry of Finance³⁶ it was arranged that the management of the Ministry of Finance shall receive on a monthly basis information treasury balance and cash floats.

Since July 1, 2007 the management of the Ministry of Finance receives information on borrowing need on a monthly basis while during previous periods it received the above information when needed (average once in two months). Currently the Ministry launched the development of the indicators system for areas of the ministry competence and this will allow to make the ingoing to the Ministry information flow more systematic.

4.2.2. Setting and monitoring borrowing need

By the decree of the Minister of Finance³⁷ a Commission for Making Decisions on Borrowing on Behalf of Government; on Purchase of Services Related to the Government Borrowing and Management of Liabilities Undertaken When Borrowing; Liabilities Undertaken by the Government When Borrowing as well as Monetary Resource Management (Commission) was established. According to its terms of reference the Commission shall make decision on ways and extent of borrowing on behalf of government, consider proposals concerning the floating securities in foreign markets, management of their circulation, taking loans and getting services under other debt liabilities and other documents related to borrowing. Decisions of the Commission are recorded.

Government Resolution set forth rules of issuing government securities to foreign market, borrowing on behalf of government and signing other debt documents³⁸. These rules stipulate that after the Law on Approvement of State Budget and Municipal Budgets Financial Indicators of respectful year or the law on amendment of the above law comes into force the Commission shall make a decision concerning ways, extent, and other conditions of Government borrowing for the next year and/or up to the end of the current year.

During the public audit we found out that although on October 28, 2005 the Commission has made a recorded decision concerning ways and extent of borrowing in foreign markets in November 2006 (on September 13, 2006 the borrowing extent was adjusted), it did not consider and make decision concerning ways and extent of Government borrowing on behalf of the state for the whole 2006 year as foreseen in the above Government Resolution. Neither 2006 borrowing need, which was submitted to the Seimas when it was approving the net borrowing limit, nor adjusted borrowing need were considered at the meeting of the Commission (see Table 13).

³⁵ State Budget, Accounting, and Payment System.

³⁶ Order of the State Secretary of the Ministry of Finance No. 23P-011(3) of 19.02.2007.

³⁷ Ministry of Finance decree No 1K-302 of 30.08.2004.

³⁸ Government Resolution No. 1377 of 20.11.2001.

Having analysed minutes of Commission's meetings of 2005-2006 and 1st quarter of 2007 we detected that they do not show sufficiently clearly on the basis of what information decisions on ways and extent of borrowing were made, and what alternative financial measures were considered.

Example

On June 15, 2006³⁹ the Commission has considered the planned borrowing need for the second half of 2006, its funding sources and made a decision concerning borrowing extent and financial instruments. On September 13, 2006 the Commission decided to increase the amount of issued Eurobond emission from MEUR 400 to MEUR 600. The minutes of the Commission meeting contain the only reason for such increase that is plans to pay 2006 year direct payments to agriculture in advance.

Worth noticing that the issued Eurobond emission amount was increased by MEUR 200 although according to the Minister of Finance decree⁴⁰ the above purposes needed only LTL 225.7 million to be borrowed.

Explanation of the Ministry of Finance

The September 13, 2006 meeting minutes contained larger amount of Eurobond emission for several reasons: payment of direct payments in advance, higher government expenditure forecasted, limited possibilities to borrow large amounts in domestic market. In addition the increased amount of Eurobonds was in line with the Government borrowing policy: to shape liquid foreign government securities emissions (emission reaching more than EUR 1 billion is considered to be liquid), which could be floated through the international electronic securities trade system.

Commission for making decisions on borrowing on behalf of government; on purchase of services related to the government borrowing and management of liabilities undertaken when borrowing; liabilities undertake by the Government when borrowing as well monetary resource management did not make decision neither on 2006 borrowing need, which shall be submitted to Seimas when approving the net borrowing limit, nor on its material amendments.

³⁹ Minutes of Commission meeting No. 12P-3-(1.38).

⁴⁰ Minister of Finance decree No. 1K-352 of 20.10.2006.

5. Borrowed Funds Management

5.1. 2006 actual borrowed funds need and use

In 2006 funds were received to borrowed funds accounts from domestic and foreign creditors as well as other refunded funds (Table 15):

Table 15. Received borrowed funds in 2006 (LTL thousand)

No.	Received borrowed funds	Amount
1.	After floating government securities abroad	3 452 219.9
2.	After floating government securities in Lithuania	1 088 126.8
3.	Foreign loans	4 999.9
4.	Refunded loans from entities (loans received on behalf of the State or with the State guarantee)	90 691.8
5.	Funds of Lithuanian Stock Innovation Bank refunded by Turto Bankas	9 000.0
6.	Funds borrowed from Reserve (Stabilisation) Fund	369 449.6

Source: Ministry of Finance

Borrowed funds, which were received to accounts of the Ministry of Finance, were used for the following purposes (Table 16):

Table 16. Use of borrowed funds in 2006 (LTL thousand)

No.	Used	Amount
1.	Domestic loans refunded	483 392.0
2.	Foreign loans refunded	130 148.0
3.	Domestic government securities bought out	2 212 158.0
4.	Foreign government securities bought out	255 507.0
5.	Transferred for funding of the State budget deficit	1 233 707.0
6.	Transferred for balancing flows of monetary resources	243 623.5
7.	Refunded loans from the World Bank and EIB	84 571.1
8.	Transferred for the programme of returning of political prisoners and deportees to Lithuania and for funding education investment project	8 300.0
9.	Transferred for direct payments to agriculture	225 693.0
10.	Refunded borrowed funds from Reserve (Stabilisation) Fund	369 449.6
11.	Transferred awarded damages to stock company Žemaitijos Pienas	5841.4

Source: Ministry of Finance

On March 28, 2007 the Government⁴¹ approved the 2006 State budget execution report developed by the Ministry of Finance, containing indication that appropriations allocated exceeded revenue, i.e. the State budget deficit was LTL 1 193 130.6 thousand including European Union funds.

In 2006 LTL 2 311 631.4 thousand were transferred from accounts of borrowed funds for funding of the State budget deficit; during the year LTL 1 077 924.6 thousand were recovered during several periods. Thus in total LTL 1 233 706.8 thousand were transferred from accounts of borrowed funds for funding the State budget deficit.

Thus it was transferred from accounts of borrowed funds for funding the State budget deficit by LTL 40 576.2 thousand more than actual State budget deficit was.

Worth noticing that in 2006 State budget execution report this information was not disclosed.

Article 3 part 7 of the Law on Public Debt stipulates that “all possible state revenue sources, including new government liabilities, shall be used to fulfil the obligations arising out of the relationships regulated by this Law”. The terms of reference of the Reserve (Stabilisation) Fund⁴² approved by Seimas stipulate that Fund resources may be used (refundably) to fund liabilities related to public debt, pension system reform, and other needs. The terms of reference do not foresee for what term funds may be allocated for funding government liabilities.

The Ministry of Finance on the basis of rules approved by the minister decree⁴³ on January 6, 2006⁴⁴ proposed to the Fund management to consider allocation of Fund money (refundably) for pension system reform and for refunding liabilities related to public debt. The Reserve (Stabilisation) Fund management made respective decisions and submitted to the Government proposals how to use allocated funds.

The Government by its resolution⁴⁵ authorised the Ministry of Finance to use (refundably) from Reserve (Stabilisation) Fund in 2006 up to LTL 450 000 thousand for fulfilment of liabilities related to public debt and stipulated that these funds shall be returned by December 31, 2006.

Note

At the beginning of 2006 the Reserve (Stabilisation) Fund balance was LTL 908 444 thousand, and when approving the 2006 State budget it was decided to allocate LTL 248 500 thousand for pension system reform. Therefore the funds left in the Fund (over LTL 659 944 thousand) might be used refundably for fulfilling state liabilities related to public debt. However the Government, as was said before, authorised the use of only LTL 450 000 thousand.

⁴¹ Government Resolution No. 304 of 28.03.2007.

⁴² Seimas Resolution No. IX-912 of 30.05.2002.

⁴³ Minister of Finance decree No. 1K-273 of 13.11.2003.

⁴⁴ Ministry of Finance letter No. (2.14-07)-6K-0600171.

⁴⁵ Government resolution No. 143 of 13.02.2006.

In 2006 the Ministry of Finance borrowed from the Reserve (Stabilisation) Fund LTL 369 449.6 thousand (i.e. by LTL 80 550.4 thousand less than was authorised), and refunded money in November 2006.

In our opinion the Ministry of Finance when planning the need of borrowed funds did not use all opportunities to use (refundably) the right ensured by the Government temporarily free funds from Reserve (Stabilisation) Fund: the Ministry did not borrow more than LTL 80 million from the amount it was entitled to borrow.

Explanation of the Ministry of Finance

One of the main purposes of the Reserve (Stabilisation) Fund is to create reserve funds, which may be used in extreme situations or when the economy faces threats. Therefore it would be not proper to use this Fund fully for fulfilling liabilities related to the public debt in normal economic conditions. This could put at risk Lithuania in case of extreme situations and economical threats when the country stays without reserve funds

During the public audit when assessing the use of funds in 2006 we found out that the Ministry of Finance following the Government resolution⁴⁶ on February 27, 2006 transferred from the borrowed funds account LTL 5 841.4 thousand to the stock company Žemaitijos Pienas executing the court decision. No funds were borrowed additionally for this compensation of damage as money from borrowed funds were used.

In our opinion the damage should be compensated first of all from funds of the programme “Compensation of material and immaterial damage made by unlawful actions of officials” managed by the Ministry of Justice”, which received in 2006 over LTL 3 million or it could be considered compensating the damage directly from the Government Reserve funds. We recommend that the Ministry of Finance in such cases first of all would use funds from the Government Reserve.⁴⁷

5.2. Investment of temporarily free state monetary resources

The State Treasury Department of the Ministry of Finance analyses the balance of State budget and borrowed funds on accounts and organises investment and management of temporarily free resources.

⁴⁶Government Resolution No. 171 of February 22, 2006 on the Mandate of the Ministry of Finance. Following Article 12 (3) of the Law on Approval Financial Indicators of State Budget and Municipal Budgets the Government delegated to the Ministry of Finance the mandate to borrow on behalf of state within the net borrowing limit the amount needed to compensate the damage awarded to the Lithuanian State by arbitration or court decision.

⁴⁷By its resolution No. 38 of January 14, 2002 the Government set forth priorities of use of State Reserve funds. One of priorities set (p.9) is that State Reserve funds may be used to compensate the damage awarded to the Lithuanian State by arbitration or court decision or to recover other expenditures while protecting interests of Lithuanian State.

When determining the investment term it should take into consideration when these funds will be necessary for funding State budget expenditure, refund public debt, and other needs.

IN order to use temporarily free state monetary resources more efficiently the Minister of Finance issued the Rules of Investment of Temporarily Free State Monetary Resources 4 Article of which stipulates that free monetary resources shall be invested immediately except the case when not invested money is kept on current account and receive interest (on such account not invested funds may remain up to 60 days).

Extract from the Rules of Investment of Temporarily Free State Monetary Resources

Point 10 of the Rules stipulates that free monetary resources may be invested into:

- Securities and financial market instruments issued by the Government or foreign countries;
 - Securities and financial market instruments issued by the Bank of Lithuania, central banks of foreign countries, ECB, international organisation to which belong at least one EU member state;
 - Securities and financial market instruments issued by domestic and foreign commercial banks;
 - Time deposits at the Bank of Lithuania, domestic and foreign commercial banks;
 - investment units (shares) publicly floated by a domestic or foreign collective investment entity
-

Since February 11, 2006 the Ministry of Finance invested temporarily free state monetary resources only into time deposits at the Bank of Lithuania although the investment rules provide other investment opportunities. In 2006 no temporarily free state monetary resources were invested into securities. Ministry of Finance invested into government securities LTL 85 693.1 thousand on January 1, 2006 and LTL 68 175 thousand at the end of the year.

During the audit the Ministry of Finance did not provide evidence (market analysis and detail calculation) that it has chosen the most efficient way of investment by making decision to invest significant amount of temporarily free state monetary resources into the Bank of Lithuania.

Example

In February and November of 2006 after Eurobonds were floated the temporarily free state monetary resources (LTL 3 625 440 thousand) were invested into time deposits in the Bank of Lithuania without considering other opportunities.

Explanation of the Ministry of Finance

One of the reasons of investment into the Bank of Lithuania was absence of clear regulation of investment into other banks except the Bank of Lithuania. Currently the description of decision making and investment procedures is developed. The other reason is that investment into time deposits is the least risky, flexible, as funds are kept in the same bank from which payments are made; investment procedures are simple, it is possible to revoke the deposit are part of it in short time.

The third reason is that investment into other instruments requires resources (including human) and the ratio of the benefit received having in mind current amounts of investments is not favourable. Therefore it was appropriate to keep deposits in the Bank of Lithuania, which has established a special unit with qualified staff for this special purpose. After the Ministry of Finance starts to invest more actively non-budgetary funds, its investment functions will be regulated appropriately it will be able to undertake measures to prepare duly for use of other investment instruments.

According to the Rules of Management of Depositors Accounts in the Bank of Lithuania approved by the Board of the Bank of Lithuania⁴⁸ deposit contracts may be drawn up if main conditions are fulfilled i.e. the amount of time deposit shall be not less than the equivalent of LTL 4 million and term of the time deposit not less than 7 calendar days. In addition, two days before the drawing up the contract there should be not less then LTL 4 million amount at the account or if the bank knows exactly, that money will be received e.g. from the previous time deposit at the Bank of Lithuania, etc.

During the public audit we found out that in some cases the Ministry of Finance has not invested temporarily free state monetary resources of a relatively long time. E.g. money on borrowed funds accounts in Euro for some periods were not invested temporarily free amounts from LTL 4 million to 100 (Table 17).

Table 17. Examples of temporarily free funds not invested during certain periods

2006-01-03 – 2006-01-26	more than LTL 6 million
2006-02-11 – 2006-03-10	from LTL 4 million to 14
2006-03-30 – 2006-04-10	more than LTL 20 million
2006-05-03 – 2006-05-18	more than LTL 8 million
2006-05-19 – 2006-05-30	about LTL 4 million
2006-06-02 – 2006-06-20	from LTL 9 million to 18
2006-07-14 – 2006-08-01	more than LTL 7 million
2006-08-04 – 2006-10-31	from LTL 7 million up to on average 10
2006-11-03 – 2006-12-02	about LTL 4 million
2006-12-07 – 2006-12-22	from LTL 28 million to 50
2006-12-29	more than LTL 100 million

Source: Ministry of Finance

Interest paid for currency balance on accounts is relatively low. According to the procedure set forth by the Bank of Lithuania and interest rates published on the web site of the ECB one can see that interests are much lower than these of time deposits. E.g. since March 6, 2006 the interest rate was 1.5 per cent, since June 15 – 1.75 per cent; since August 9 – 2.00 per cent; since October 11 – 2.25 per cent, and since December 13 – 2.05 per cent.

Explanation of the Ministry of Finance

Ministry of Finance when monitoring flows of state monetary resources considers balances of accounts as the whole of money at disposition, which is used as necessary. As there are possible deviations from revenue and expenditure forecasts the Ministry keeps a certain funds reserve for the case if forecasts would turn to negative. By the end of the year the money balance increased because forecasts for December are always more complicated.

⁴⁸ Bank of Lithuania Board resolution No. 238 of December 31, 1998 (new version No. 168 of December 28, 2006) on The Improvement of the Rules of Depositors' Accounts Management in the Bank of Lithuania.

Temporarily free state monetary resources are not invested for a relatively long time. In our opinion, the Ministry of finance should analyse and assess opportunities to invest funds into other credit institutions, as it was foreseen in the Rules of investment of temporarily free state monetary resources; it should also make investment procedures faster and develop procedures regulating decision making and investment into other credit institutions.

6. Debt Liabilities to the State

According to Article 2 part 10 and 11 the borrower shall mean a legal person of the Republic of Lithuania, or a citizen of the Republic of Lithuania or a resident of Lithuania who has received a loan from the funds borrowed on behalf of the State under a loan agreement concluded with the State or under other debt instruments and who assumes the obligation to the State regarding the use and repayment thereof. If the loan received under the state guarantee the repayment of a debt wholly or in part and payment of interest on the debt or part thereof to be repaid is guaranteed by the State.

On December 31, 2006 the amount of unpaid loans, interests, and late payment interests on funds borrowed on behalf of the state made LTL 1 479 406 thousand; loans under state guarantees made LTL 791 353.6 thousand, and economic entities liabilities to the state under the guarantees fulfilled (loans, interests, and late payment interests) made LTL 417 927 thousand.

Since 2003 loans to economic entities under guarantee of the state are not provided. In 2006 no new loans from funds borrowed on behalf of state were provided (except loans planned for funding of investment projects).

Following the Rules of Grouping Loans and Liabilities approved by the decree of the Minister of Finance⁴⁹ loans from funds borrowed on behalf of state are funds received with the state guarantee are divided after the liabilities conditions into risk groups depending on borrower's risks factors. Groups of risk factors are determined taking into account the following: delay of loan or interest payments; facts of rearrangement or refunding debt; economic and financial situation; actual implementation of the investment project by the receiver of long-term (investment) loan. The distribution of borrowers and liabilities to the state by years and risk groups is demonstrated in Table 18.

⁴⁹ Minister of Finance Decree No. 1K-068 of March 2, 2007.

Table 18. Distribution of borrowers and liabilities by years and risk groups⁵⁰ (LTL thousand)

	Unpaid part of loan by risk groups									
	5 risk group		4 risk group		3 risk group		2 risk group		1 risk group	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Loans provided from funds borrowed on behalf of state including:	19	191814,7	12	143389,3	7	2785,7	41	1014231,3	3	21776,8
by 1997	25	177037,5	20	40448,7	6	2426,4	17	31287,7	1	0
1998–2000	-	-	6	51095,5	-	-	17	795823,1	3	12511,3
after 2000	3	14777,2	2	51845,1	1	359,3	13	187120,5	1	9265,5
Loans received with the state guarantee including:	4	5593,1	7	162729,5	1	32800,3	10	590230,7	0	0
by 1997	4	1889,2	5	3677,3	-	-	15	58760,1	-	-
1998–2000	-	-	4	20788,2	-	-	12	120430,7 ⁵¹	-	-
after 2000	1	3703,9	4	138264,0	1	32800,3	3	411039,8 ⁵²	-	-
Total	23	197407,8	27	306118,8	8	35586,0	51	1604462,0	3	21776,8
Total under loans received before 2000										1316175,7
Total by 1–5 risk groups										2165351,3

Having assessed that LTL 1 292 966.3 thousand of unpaid debt owed stock company Mažeikių nafta and State Social Insurance Fund Board (both entities belong to the 2nd risk groups and had no problems with repaying debts) we see that the amount of unpaid debt by other borrowers belonging to 5th and 4th risk group makes LTL 503 526.6 thousand or 57.7 per cent, which refunding to the state may cause additional expenditure.

The major part (60.8 per cent) of unpaid loans (LTL 2 165 351.3 thousand) consists of loans provided by 2000; the total part of unpaid debt makes LTL 1 316 175.7 thousand. The major part of these loans is provided to 5th and 4th risk group.

⁵⁰ Data for December 31, 2006 m. Numbers of entities by years differ from the total amount because some entities have received few loans during various years.

⁵¹ Also Mažeikių Nafta part of funds borrowed on behalf of state is KLTL 763795,8 and unpaid part of the loan received makes KLTL 429170.5.

⁵² Also State Social Insurance Fund unpaid part of the loan received makes KLTL 100 000.

In Annex 6 of the report we show the comparison of the distribution of debt liabilities in 2004-2006 by risk groups.

Note. The part of unpaid debt by entities of the 5th and 4th risk group is decreasing and the main reason is the write-off of bad loans. Since 2004 the number of borrowers of the 5th group decreased from 47 to 23, and the part of the debt unpaid from LTL 463 455.9 thousand up to LTL 197 407.8 thousand. Following the provisions of the Law on Public Debt and Rules of Writing Off, Accounting and Revising Debts and Loans Acknowledged to Be Bad⁵³ the Government⁵⁴ since 2002 each year acknowledges some debt liabilities to be bad.

Note

In 2002–2006 loans, debts or their unrefunded parts were acknowledged to be bad for 276 economic entities and amounted LTL 410 996.3 thousand. By the end of 2006 this amount was still not recovered i.e. the state had to refund this amount from state funds.

Funds from refunded loans and interests are planned in a conservative manner i.e. expecting to collect less funds from respective risk groups: no funds are planned to be recovered from entities of the 5th risk group, 60 per cent to be recovered according to payment schedules from entities of the 4th group, 80 per cent from the 3rd group, and only from the 1st and 2nd group the funds are expected to be recovered at 100 per cent.

The debt recovery practice of previous years proves that the majority of debts from the 5th and 4th risk groups are not recovered, the recovery makes a problem (only a small part of debts is actually recovered).

Having assessed that the majority of loans received on behalf of government are already refunded to creditors it is probable that about LTL 41 million of loans borrowed on behalf of state and relended to entities will be refunded by the state. The state will also have to refund part of debt received under state guarantee, which potentially can reach about LTL 77 million. Public auditors assessed that the state cannot recover from debtors whose debts were refunded up to LTL 275 million.

⁵³ Government Resolution No. 1249 of October 19, 2001.

⁵⁴ Government resolutions: No. 893 of June 13, 2002, No. 2028 of December 20, 2002, No. 649 of May 27, 2003, No. 1603 of December 16, 2003, No. 367 of April 6, 2004, No. 854 of July 7, 2004, No. 19 of January 13, 2005, No. 116 of February 2, 2006, No. 1297 of December 2006.

7. Performance of the Internal Audit Service of the Ministry of Finance

Internal Audit Service of the Ministry of Finance has not yet conducted a performance and management assessment audit of the State Treasury Department, which is responsible for implementation of the state borrowing policy; the audit is planned to be carried out by the end of 2007⁵⁵. It is planned to assess whether the State Treasury Department has developed and implemented the system of internal control, which ensures that the Ministry implements soundly the state policy of managing state monetary resources on accounts at the State Treasury, the general State Treasury system management, and state policy of borrowing on behalf of state. The internal auditors did not assess the programme “Public Debt Management”; such assessment is not included into the 2007 action plan of the Internal Audit Service.

The Financial Market Department of the Ministry of Finance is responsible for efficiency of management and recovery of debts to the state. The assessment of this department management and performance conducted by the Internal Audit Service of the Ministry in 2006⁵⁶ revealed material shortcomings of internal control, management of debt recovery instruments, grouping of debts and liabilities, assessment of special extensions, assessment of debtors’ economic and financial situation, staff training, data and information protection, and other areas.

The Ministry of Finance taking into consideration findings of internal auditors has undertaken measures for implementation of recommendations. Recommendations provided by the Internal Audit Service and information on their implementation are provided in Annex 6 of the report.

⁵⁵ The Ministry of Finance Internal Audit Plan for 2007.

⁵⁶ Internal Audit Service of the Ministry of Finance report No. 16.2-A-14 of October 2, 2006.

8. IT Systems for Public Debt Management

8.1. Overview of current situation

The IMF and World Bank Guidelines for Public Debt Management recommend that the priority of sound debt management strategy should be use of IT systems, which ensure efficient public debt management.

In the 2006-2008 Strategic Action Plan of the Ministry of Finance stipulated that the Ministry seeks to improve the debt management IT system as the current debt management and accounting IT system is not integrated, there are several systems, which do not ensure efficient debt management and accounting.

The Ministry of Finance ordered company Bull S.A. to analyse the current environment and within the project “Modernisation of public debt and monetary resources management functions” report⁵⁷ provided conclusions concerning current information system and technologies. The report underlines that current formal and informal information systems were developed during a relatively long time in situation of lack of funds to be invested into IT. The systems were designed individually without a general vision of IT development seeking to meet special needs of individual units of the Ministry of Finance.

Summary of the current situation of information systems:

- All used programmes are only partly integrated or are not integrated at all although they work with logically related data;
- Functionality of any information system cannot fully meet the needs therefore the Ministry staff uses both formal information’s systems and informal tools developed in the MS Excel environment;
- Information systems used for public debt and monetary resources management were created on the basis of different data basis management systems (*Access, Oracle, Visual FoxPro, Navision*) and this makes difficult system integration and puts at risk integrity of data;
- Links with external information systems (i.e. information systems in other organisations as well as systems used by other units of the Ministry of Finance) are automated only partly;
- Some of used technologies (Oracle 7) are out of date;
- Some information systems used for public debt and monetary resources management are not consistently updated (e.g. DMFAS), do not fully meet users’ needs.

Any of current information systems does not perform needed analysis and reporting functions. Usually MS Excel spreadsheets are used for these purposes into which is transferred and further

⁵⁷ Bull.S.A. on order of the Ministry of Finance.

processed information from formal information systems especially DMFAS. This not only reduces the productivity of staff but also increases probability that reports will lack the most urgent data.

Not fully integrated data structure causes the situation when data necessary for reporting are collected manually, transferred from one unit to another in various forms (paper reports, MS Excel spreadsheets, MS Word documents, etc.). The problem especially sharp when informal systems are used to store and process data, which are used for making forecasts, the reliability of which has direct effect on the efficiency of the debt and monetary resources management as well as the management of related risks.

The Ministry of Finance has no common data storage, which is necessary for training analytical skills and developing reports more efficiently. In the absence of such storage it is impossible to carry out functions of detail analysis.

Due to the above reasons the public debt and monetary resources management and flows forecasting require much manual work and additional control, increases error probability, does not provide with timely information. The public debt and monetary resources management IT system should be improved.

It is worth underlying that public debt management information systems are updated using the new subsystem of the State Budget, Accounting and Payments System (VBAMS). This system should enable to solve all the above problems (for more details see chapter 8.2 of the report).

8.2. Development of public debt and state monetary funds management IT system

The goal of the Public Debt and Monetary Resources Management System (VSPIVS) shall be to help to ensure the efficient monetary resource management and to modernise and optimise the public debt management. The IT Strategy for the Public Debt and Monetary Resource management of the Ministry of Finance for 2004-2006 stipulated the installation of the on the shelf product having data integration (data storage) functions and analysis instruments, links with bank systems, news agencies (*Bloomberg*, *Reuters*) data, and “potential of further development and modules, which might in future replace the Navision at the Treasury level”⁵⁸.

⁵⁸ 2004–2006 IT Strategy approved by the Ministry of Finance IT Management Committee by the protocol No. 2 of December 2, 2004.

According to the Minister of Finance decree⁵⁹, VSPIVS shall be designed as a VBAMS subsystem. The Rules of Development and Legalisation of State Information Systems require that founders of information systems shall design terms of reference of the system and technical specifications of the project⁶⁰. The terms of reference of the VBAMS were approved by the Minister of Finance⁶¹ in 2006 and registered at the Information Society Development Committee under the Government (IVPK)⁶². The VBAMS terms of reference do not contain VSPIVS organisational, information, and functional structure, the VSPIVS specification in line with requirements with Lithuanian legislation⁶³ was not designed.

When designing VSPIVS the Ministry of Finance did not follow requirements of the Rules of Development and Legalisation of State Information Systems approved by the Government Resolution No. 451 of April 19, 2004.

Explanation of the Ministry of Finance

During 2007 the Ministry plans to design amendments of VBAMS terms of reference taking into consideration changes of the organisational, information, and functional structure of the information system in place. It also plans to design a VBAMS specification project, which should cover the State Treasury subsystem of VBAMS and the State Budget subsystem of VSPIVS and VBAMS.

In our opinion some requirements of methodological documents of the Rules of Development and Legalisation of State Information Systems contradict information system specification aspect of the Law on Public Procurement.

The State Investment Programme for 2006–2008 assigned for computerised VBAMS installation and modernisation LTL 2 750 thousand⁶⁴. In 2006 LTL 2 749.8 thousand were spent for VBAMS⁶⁵ including LTL 2 100 thousand for VSPIVS development service⁶⁶.

When implementing the VSPIVS project the Ministry planned to develop a new public debt and monetary resources management system⁶⁷. VSPIVS was planned as the part of VBAMS the Ministry of Finance planned for 2006 VSPIVS acquisition, installation, and maintenance services contract⁶⁸.

⁵⁹ Minister of Finance decree No. 1K-102 of March 20, 2007.

⁶⁰ Government Resolution No. 451 of April 19, 2004.

⁶¹ Minister of Finance decree No. 1K-152 of April 6, 2006.

⁶² Information Society Development Committee under the Government letter No. (65)-S-449 of April 14, 2006.

⁶³ Information Society Development Committee under the Government Director decree No. T-131 of October 15, 2004.

⁶⁴ Government Resolution No. 131 of February 8, 2006.

⁶⁵ Ministry of Finance report No. 15-2/29 of February 2, 2007 on use of state funds assigned for investments funding by appropriations managers and investment projects by January 1, 2007.

⁶⁶ Contract between the Ministry of Finance and SIA Lattelecom Technologies No. (1.35)-14P-57 of November 6, 2006.

⁶⁷ Introductory report of the Project Modernisation of Public Debt and Monetary Resources Management Functions implementer Bull S. A. Of October 24, 2005.

⁶⁸ Contract among the Ministry of Finance and SIA Lattelecom Technologies No. (1.35)-14P-57 of November 6, 2006.

Following the provisions and project management scheme designed by the IT Management Committee and laid down in the IT Strategy of The Ministry of Finance for 2004-2006 the IT Management Committee had to set forth IT priorities, take part in development and improvement of projects designed and support scenarios. Public auditors have detected that the IT Committee of the Ministry of Finance did not hold a single meeting and never considered the process of the VSPIVS project implementation.

Legislation of the Republic of Lithuania does not regulate the management of information systems projects in state institutions. The international practice shows that standard IT project management approaches should be applied. The Ministry of Finance currently have trained four IT project management specialists able to apply internationally recognised standard IT project management approaches. The NAOL auditors also have expressed the opinion on possibility of wider and formalised application of internationally recognised approaches of project management, information systems development and other similar methods in the Ministry of Finance in 2006⁶⁹.

In opinion of public auditors the IT Management Committee did not carry out proper control of the VSPIVS project.

⁶⁹ The NAOL report No. IA-9000-2-1 of July 13, 2006 “The Overall Control of Information Systems of the Ministry of Finance. Control of the EU Structural Funds and EU Cohesion Fund financial information computerized system management and maintenance”.

CONCLUSIONS AND RECOMMENDATIONS

Conclusions

1. Structure and trends of the public debt

1.1. During the few recent years there is a trend of decrease of public debt to GDP ratio. By the end of 2006 the public debt of Lithuania compared to GDP comprised 18.2 per cent (one of criteria set forth by the Maastricht Treaty i.e. government sector debt shall be not higher than 60 per cent of GDP or otherwise it should be rapidly decreasing) and is one of the lowest among EU member states. (Chapter 1.1)

1.2. The structure of the public debt dominated by long-term debt liabilities the majority of which is comprised of securities (Eurobonds). Such debt structure meets provisions of IMF and World Bank Guidelines for Public Debt Management and is of an acceptable risk. (Chapter 1.2)

2. Public debt strategy

2.1. Description of the Government of the Republic of Lithuania Medium-Term Borrowing Policy Guidelines provide with public debt management goals, directions, structure priorities, and debt liabilities limits up to 2009 however in our opinion the indicators should be more specific. Although the reduction of debt is programmed in provisions of the Law on Public Debt concerning borrowing objectives as well as documents on fiscal policy formation these acts do not set forth the use of public funds in case of non-deficit or profit budget, optimal level of debt, which would not influence the sustainability of government sector finance. (Chapters 2.2 and 2.3)

2.2. Legal acts of the Republic of Lithuania as well as reports on public debt produced by the Ministry of Finance do not define sufficiently clearly and reveal potential risks concerning public debt, acceptable, tolerable level of each risk and mitigating measures, which could ensure the efficient risks management. (Chapter 2.4)

2.3. The Ministry of Finance in principle ensure the management of basic public debt risks (risks of refunding, currency rate deviation, and interest rate). However it is worth noticing that the Ministry of Finance:

- ▶ when managing market risk does not yet apply stochastic simulation model based on cost at risk, which is planned to be used since 2004;
- ▶ does not apply stress tests recommended by IMF and World Bank Guidelines for Public Debt Management when modelling economical and financial shocks, to which the state is potentially vulnerable;
- ▶ does not reveal and assess sufficiently the potential influence of miscellaneous liabilities and fiscal threats on the public debt. (Chapter 2.4)

3. Programme “Public Debt Management” implemented by the Ministry of Finance

3.1. Programme measures meet functions of the Ministry of Finance in public debt management and debt liabilities administration areas and by implementing the given measures the Ministry is able to achieve programme objectives. However in our opinion these measures are not specific; the accountability for their implementation should also be improved. (Chapter 3.1)

3.2. Evaluation criteria do not provide enough information on implementation of goals and objectives of the Programme. (Chapter 3.2)

4. Borrowing need and management of state monetary resources

4.1. Rules of assessment of the borrowing need should be improved. (Chapter 4.1)

4.2. The Government Annual Borrowing Programme, which is submitted alongside with Draft Law on Improvement of Financial Indicators of State and Municipal Budgets for respectful year, does not contain detail information on the planned Government borrowing structure. (Chapter 4.1)

4.3. The state monetary resources management should be improved: there is no approved procedure regulating forecasting, management, and accountability of state monetary resources therefore there is a risk that cash flows forecasts affecting borrowing need and investment of temporarily free state monetary resources may be not reliable and urgent. (Chapter 4.1)

4.4. The Commission for Making Decisions on Borrowing on Behalf of Government; on Purchase of Services Related to the Government Borrowing and Management of Liabilities Undertaken When Borrowing; Liabilities Undertaken by the Government When Borrowing as well as Monetary Resource Management established by the Ministry of Finance did not make decision on 2006 borrowing programme (2006 borrowing need) and its significant amendments. (Chapter 4.2)

5. Management of borrowed funds

5.1. When forecasting 2006 borrowing need the Ministry of Finance did not use the right given by the Government to use (refundably) temporarily free funds from state monetary funds (Reserve (Stabilisation) Fund). (Chapter 5.1)

5.2. The Ministry of Finance in 2006 invested temporarily free monetary resources only into time deposits of the Bank of Lithuania and thus did not use all investment opportunities i.e. the temporarily free monetary funds were not invested for a relatively long period. (Chapter 5.2)

6. Liabilities to the state

6.1. The majority of unrefunded loans (LTL 503 526.6 thousand or 58 per cent) comprise debts of the 4th and 5th (high) risk groups, which recovery may require additional spending of the state. Having assessed the fact that the majority of loans received on behalf of the state are already refunded to creditors it is probable that a. LTL 41 million of loans received on behalf of the state

and relent to entities as well as a. LTL 77 million of loans received by entities with state guarantee will be paid by the state. The state may not recover from debtors whose debts it has already paid a. LTL 275 million more. (Chapter 6)

7. Public debt management IT systems

7.1. Public debt and monetary resources management information system needs improvement: public debt and monetary resources management as well as flows forecasting requires a lot of manual work and additional control procedures. This increases error probability, does not provide information in time. Currently public debt management information systems are under modernisation while installing a subsystem of a new State Budget, Accounting, and Payments System (VBAMS). (Chapter 8.1)

7.2. Ministry of Finance does not follow requirements of the Rules of Development and Legalisation of State Information Systems. The management of the Ministry of Finance did not ensure the proper control of the VSPIVS project. (Chapter 8.2)

Recommendations

To the Government of the Republic of Lithuania:

1. To review periodically the Medium-Term Public Debt Management Strategy by revising debt management objectives and indicators.
2. To consider possibility to enter into legislation a provision that unplanned State Budget revenue received after a zero balance of the government sector will be reached shall be used for reduction of the public debt.

To the Ministry of Finance:

3. In order to ensure more efficient debt risk management:
 - to urge the application of the debt stochastic simulation model based on cost at risk method;
 - to set a procedure of stress tests and to apply them on a regular basis;
 - to assess miscellaneous state debt liabilities and fiscal threats and properly disclose information on them in explanatory letter on the current year State Budget Execution Report or draft State Budget documents.
4. To set forth more specific measures, assessment criteria, and accountability for the implementation measures of the Programme “Public Debt Management”.
5. To improve rules of borrowing need assessment.
6. To improve disclosure of information in the annual Government Borrowing Programme.

7. To set forth a procedure regulating state monetary funds management, forecasting, and accountability.

8. To specify the terms of reference of the Commission for Making Decisions on Borrowing on Behalf of Government; on Purchase of Services Related to the Government Borrowing and Management of Liabilities Undertaken When Borrowing; Liabilities Undertaken by the Government When Borrowing as well as Monetary Resource Management in order this Commission could make decisions on annual borrowing need indicators and significant amendments.

9. When revising the Law on Approvement of Financial Indicators of State and Municipal Budgets for 2007 propose to review the Government net borrowing limit.

10. When forecasting need of borrowed funds to assess all possibilities provided by the Government for use of temporarily free money of state monetary funds.

11. In order to manage state monetary funds more efficiently to speed the investment of temporarily free state monetary resources, to consider opportunities of investing into other credit institutions and to improve legal regulation of investment procedures.

12. Further improve the Public Debt and Monetary Resources Management IT System. When developing the VSPIVS:

- ▶ to use possibilities of the IT Management Committee;
- ▶ to improve provisions of the VSPIVS project monitoring committee terms of reference;
- ▶ to improve strategic planning process of information system.

Director of 6th Audit Department

Jolita Korzunienė

Principal Public Auditor

Erika Latyšovič

ANNEXES

Annex 1

Audit scope and process

During the audit the following data and information were analysed:

- Public information (press releases, web sites of various institutions, periodical press, etc.) and statistical data concerning state borrowing and debt management, trends of macroeconomical indicators;
- Strategic Action plan of the Ministry of Finance for 2006–2008;
- Lithuanian Convergence Programme for 2006;
- National Lisbon Strategy Implementation Programme;
- Description of the programme “Public Debt Management” implemented by the Ministry of Finance;
- Law on Public Debt, Laws on Approvement of Financial Indicators of State and Municipal Budgets for 2006 and 2007, Government resolutions, internal acts of the Ministry of Finance regulating public debt management, borrowing on behalf of government, management of borrowed funds, setting debt and borrowing limits, etc.;
- Statements of central government debt, state guarantees to creditors, loans given from borrowed funds, statements of debts developed by the Ministry of Finance;
- Terms of reference, job descriptions of Ministry of Finance units responsible for public debt management programme design, monitoring, and implementation of planned measures, public debt administration and recovery, etc.;
- Internal audit plans for 2006 and 2007 of the Internal Audit Service of the Ministry of Finance;
- Internal audit report “Management and performance of the Financial Market Department of the Ministry of Finance” of October 2, 2006 carried out by the Internal Audit Service of the Ministry of Finance.

When conducting the audit we followed the Public Audit Requirements adopted by the NAOL, provisions of IMF and World Bank Guidelines for Public Debt Management, INTOSAI Public Debt Committee documents, examples of good practice of foreign SAIs, and other documents. When assessing Public Debt and Monetary Resource Management IT System development we followed methodical recommendations on information systems approved by the Auditor General, 22nd

guideline of Guidelines for Implementation INTOSAI Audit Standards in Europe, ISACA International Auditing Standards and ISACA Audit Guidelines and good practice.

During the audit we interviewed the management and specialists of the Ministry of Finance, analysts and economists of the Bank of Lithuania and commercial banks, auditors from foreign SAIs who audited public debt management issues.

The assessment period of the public debt management strategy shaping is 2000-2009. We assessed trends of debt changes, debt-to-GDP ratio, debt-to-revenue and other indicators ratio, ability of the state to refund debts, etc.; borrowing limits set forth in the Law on Approval of Financial Indicators of State and Municipal Budgets and how they are followed; how the 2006 borrowing need was set forth, how temporarily free state monetary resources were managed.

Concept and abbreviations used:

GDP – Gross domestic product.

VVP – Government securities.

IT – Information technology.

VBAMS – State Budget, Accounting, and Payments System.

PHARE – *Poland and Hungary; aid for economic restructuring* Programme of EU and Central and Eastern Europe cooperation.

VSPIVS – Public Debt and Monetary Resources management System.

INTOSAI – International Organisation of Supreme Audit Institutions linking SAIs of countries belonging to UN or UN specialised agencies.

Ministry of Finance – Ministry of Finance of the Republic of Lithuania.

Government – Government of the Republic of Lithuania.

Central Government Sector – state budgetary institutions, extrabudgetary funds, state enterprises, which do not produce for market and which are controlled and dominantly funded by the central government.

Local Government Subsector – municipal budgetary enterprises, municipal enterprises, which do not produce for market, public entities, which do not produce for market and which are controlled and dominantly funded by local governments.

Social Security Funds Subsector – State Social Insurance Fund Board, Compulsory Health Insurance Fund budget, and Employment Fund.

Financial Instrument – any transaction, which determines production of assets for one of transaction parties, and financial liability for another transaction party.

Derivative – financial instrument (future contract, forward contract, etc.), the value or price of which is linked to the value or price of the basic goods as well as financial instrument the value or price of which is linked to the value or price of securities, currency rate, interest rate, stock exchange index, credibility and other values.

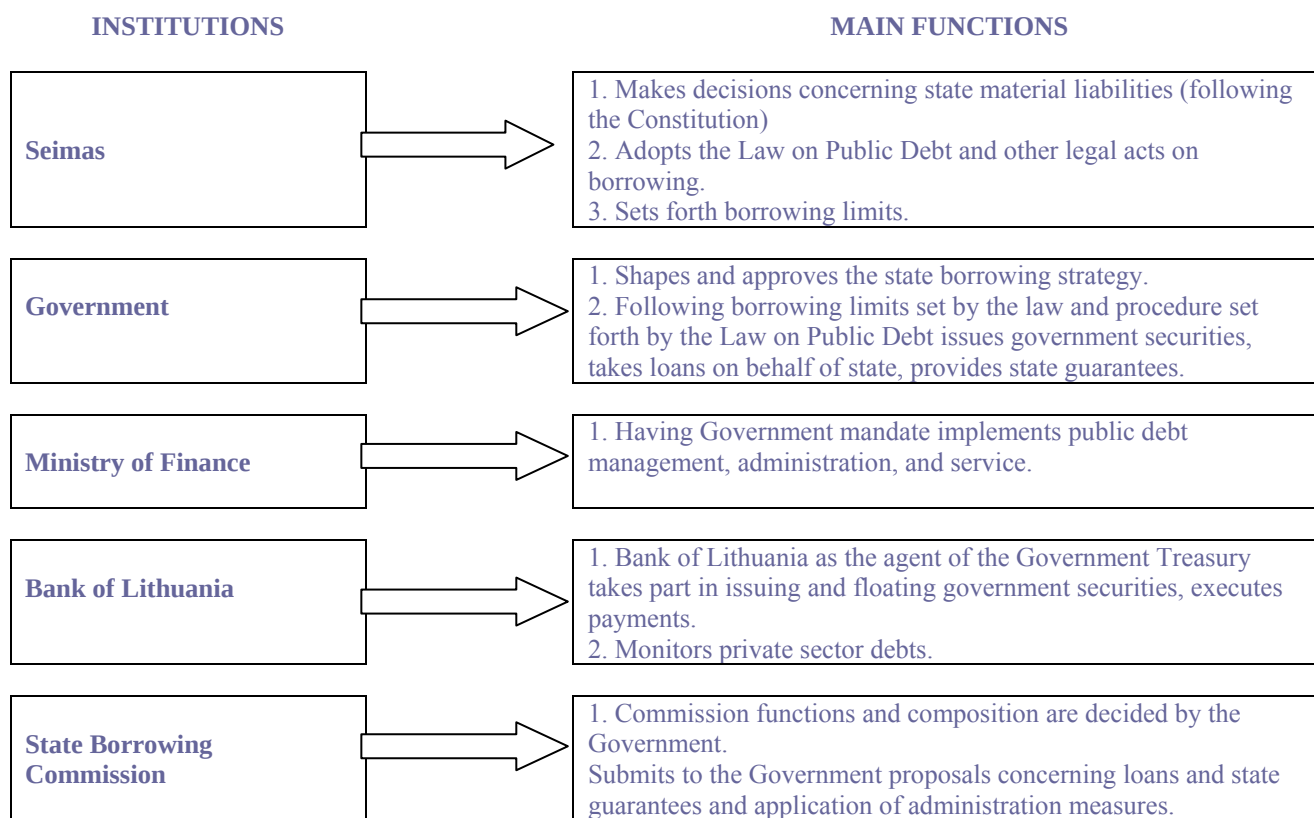
Liquidity – a feature of investments, which provides an investor with possibility to sell his investments at lowest risk and at any time at the price closest to market prices.

Deterministic simulation model – a model allowing to compare few borrowing strategies and to assess debt portfolio parameters at different currency rates, interest rates, and borrowing need scenarios.

Debt portfolio (funds borrowed on behalf of government) – funds borrowed by the Ministry of Finance representing the Government following the procedures set forth by the Government, received having floated government securities, signed loan agreements, and other liability documents.

Other debt liabilities – commitment undertaking when borrowing (except liabilities undertaken by floating government securities, signing loan contracts, leasing contract, providing with state guarantees) to refund the amount indicated in documents on conditions agreed in these documents (commercial papers, promissory and payable bills, deposited certificates, etc.).

Fig. 6. Institutions of the Republic of Lithuania related to the public debt management



Source: NAOL

Annex 3

Extract from the Description of the Government of the Republic of Lithuania Medium-Term Borrowing Policy Guidelines

- The Government borrowing need shall be funded in Litas and Euro or other currency, which shall be converted into Litas or Euro using derivatives.
 - Debt liabilities shall be reduced in those currencies, fluctuation of rate of which to Litas and Euro may cause unwanted fluctuation of debt management costs.
 - The Government borrowing need shall be mostly funded by issuing government securities in domestic and foreign markets.
 - Government monetary resources flows shall be balanced using State Treasury bills, credit lines, repurchase agreements, and other short-term borrowing instruments.
 - When issuing government securities in domestic market it shall be concentrated on 3, 5, and 10 year borrowing terms and few relatively liquid emissions shall be created. In addition, seeking to increase the liquidity of government securities forward government securities auctions shall be organised as well as other financial instruments shall be used.
 - It is planned to seek that Euro denominated government securities shall make the increasing share of debt liabilities on behalf of state. It is also to be sought to develop relatively large and liquid Euro denominated government securities emissions, which could be traded through international electronic securities trading systems.
 - It shall be sought to develop the best opportunities to domestic and foreign investors to purchase government securities, to promote the merging of domestic and Euro zone markets
-

Annex 4

Table 19. Comparison of Lithuanian, Latvian, and Canadian borrowing limits

Latvia (Central Government Debt Management Strategy ⁷⁰)	Lithuania	Canada (2007-2008 Debt Management Strategy ⁷¹)	Comparison (commentary)
Share of debt in Latas of the whole debt: at least 35 per cent. Share of foreign debt in Euro 100/-5 per cent.	N/A		Actual indicators in 2006 in Lithuania: debt in Litas 18 per cent; in other currencies 82 per cent. Until 2003 the limit was set: at least 75 percent of debt in Euro. Recently no debts taken in other currencies, the majority of foreign public debt received in Euro.
Share of debt shorter than 1 year no more than 25 per cent.	Short term debt liabilities should not exceed 30 per cent of all government debt liabilities.		This indicator in Latvia and Lithuania treated equally however in Lithuania debt liabilities has a broader meaning.
Share of debt shorter than 3 years no more than 50 per cent.	When issuing government securities in domestic market it shall be concentrated on 3, 5, and 10 year borrowing terms and few relatively liquid emissions shall be created.	2007-2008 emissions of 2, 5, 10, and 30 year term shall be supplemented.	
Share of debt with fixed interest rate shall make 60–70 per cent.	No more than 25 per cent of state debt liabilities shall be with floating interest.	In 2007-2008 to finish the transition to such debt structure, in which the share of debt with fixed interest will reach 2/3 – 60 per cent.	The indicator is similar to that of Latvia however in Lithuanian the requirement is sharper (25 per cent while in Latvia 30-40 per cent.).
N/A.	Expenditure for interest for receive loans, government securities floated, and other liabilities on behalf of government shall not exceed 10 per cent of planned annual tax revenue collected to the State Budget.		The indicator shows what part of tax revenue the state is going to use for interest expenditure.

Source – Ministries of Finance of Lithuania, Latvia, and Canada

⁷⁰ Latvian Central Government Debt Management Strategy, Minister of Finance, 2006.⁷¹ Debt management Strategy 2007-2008, Department of Finance Canada.

Annex 5

Table 20. 2006 funds lent and refunded by financial instruments (LTL thousand)

No.	Received and refunded	Amount
	Foreign liabilities	
1	Government securities	
1.1.	Floated	3 452 800,00
1.2.	Redeemed	255 507,00
2	Loans	
2.1.	Received	84 352,00
2.2.	Refunded	130 148,00
	Domestic liabilities	
3	Government securities	
3.1.	Floated	1 100 000,00
3.2.	Redeemed	2 175 892,00
4	Objective government securities	
4.1.	Floated	0,00
4.2.	Redeemed	45 663,00
5	Loans	
5.1.	Received	0,00
5.2.	Refunded	483 392,00
	Total: received / floated	4 637 152 ,00
	Total: refunded / redeemed	3 090 602 ,00
	Difference	1 546 550,00

Source: Ministry of Finance

Annex 6

Table 21. Distribution of debtors and debt liabilities by debt risk groups (LTL thousand)*

	Unredeemed share of debt by risk groups									
	5 th risk group		4 th risk group		3 rd risk group		2 nd risk group		1 st risk group	
	number	amount	number	amount	number	amount	number	amount	number	amount
Loans provided from funds borrowed on behalf of state	19	191814,7	12	143389,3	7	2785,7	41	1014231,3	3	21776,8
Loans received with the state guarantee	4	5593,1	7	162729,5	1	32800,3	10	590230,7	0	0
Total	23	197407,8	19	306118,8	8	35586,0	51	1604462,0	3	21776,8

* Data of December 31, 2006

Table 22. Distribution of debtors and debt liabilities by debt risk groups (LTL thousand)*

	Unredeemed share of debt by risk groups									
	5 th risk group		4 th risk group		3 rd risk group		2 nd risk group		1 st risk group	
	number	amount	number	amount	number	amount	number	amount	number	amount
Loans provided from funds borrowed on behalf of state	29	306173,8	13	137610,6	7	4192,1	45	1091731,2	3	25976,5
Loans received with the state guarantee	6	35570,0	7	188468,9	1	34390,0	13	716594,6	0	0
Total	35	341743,8	20	326079,5	8	38582,1	58	1808325,8	3	25976,5

* Data of December 31, 2005

Table 23. Distribution of debtors and debt liabilities by debt risk groups (LTL thousand)*

	Unredeemed share of debt by risk groups									
	5 th risk group		4 th risk group		3 rd risk group		2 nd risk group		1 st risk group	
	number	number	number	number	number	number	number	number	number	number
Loans provided from funds borrowed on behalf of state	39	397843,4	17	160500,1	8	28150,1	46	1024334,4	3	30606,0
Loans received with the state guarantee	8	65612,5	9	215203,9	2	119753,1	16	609512,1	0	0
Total	47	463455,9	26	375704,0	10	147903,2	62	1633846,5	3	30606,0

* Data of December 31, 2004

Annex 7

Table 24. Implementation of recommendations of the audit “Assessment of Financial Market Department Management and Performance” carried out by the Internal Audit Service of the Ministry of Finance

Recommendation	Implementation measure	Implementation
To prepare and sign immediately extension contracts as well as refunding ensuring actions agreements with debtors.	To require signing the debt extension contract from stock company “Tauragės šilumos tinklai”. To address three debtors who did not ensure liability fulfilment by hypothecating assets of receiving local government guarantees; to require submitting one of these measures.	UAB „Tauragės šilumos tinklai“ (at the beginning of 2007) and UAB „Rietavo komunalinis ūkis“ (at the end of 2006) have already returned the rest of the debt. UAB „Gelvita“ is solvent and currently refunds debt in time; by 31.12.2006. its debt was 12 KUSD. UAB „Gelvita“ has asked the Ministry of Finance to allow refunding the whole debt and asks not to make a mortgage contract because of the high price of assets evaluation. UAB „Plungės šilumos tinklai“ on 29.12.2006 received a mortgage note. Mortgage contract were signed with all other debtors.
To design the procedure of registration and storage of debt extension contracts, their amendments and additions, and documents proving the refunding of debt, to validate it properly and to follow it.	To design and submit to the Minister of Finance for approval rules of registration of contracts, their amendments and additions prepared by the Financial Services Division.	The rules adjusted journals of contracts, their amendments and additions approved by the decree No. 1K-027 of February 1, 2007.
Following the set procedure to group loans and liabilities, to assess correctly need of special extensions, and to ensure proper internal control.	To adjust job descriptions of the Financial Services Division staff and to set special functions related to loans grouping.	Job descriptions of the Financial Services Division staff adjusted.
To design and approve following the set procedure of attributing debtor's economic and financial indicators to a certain level and to ensure correct assessment; to ensure proper internal control. To manage properly debtors' files and to keep in them information, which is necessary for assessment of debts and loans risk.	To adjust Loans and Liabilities Grouping Rules approved by the Minister of Finance decree No. 96 of April 14, 1999 setting the procedure of attribution of debtors' economic and financial indicators to certain level.	The Ministry of Finance decree No. 1K-068 of March 2, 2007 amended the rules and procedure, approved criteria for debtors' economic and financial situation assessment.
Recommend to the management of the Ministry of Finance to appoint a person to represent shareholder (Ministry of Finance), which could take part in AB Turto bankas proceedings with advisory vote.	To ask in written the secretary of the Ministry of Finance management proposing a person to represent shareholder (Ministry of Finance), which could take part in AB Turto bankas proceedings with advisory vote.	Ministry of Finance letter No. (7.7-01)-19K-S0555 of November 9, 2006.
To ensure participation of the Financial Markets Division staff in training, improving their professional knowledge necessary for fulfilment of their functions.	To address in written the Ministry Personnel Department proposing to develop the description of general procedure concerning staff training.	Information on the participation of Financial Service Division of the Financial Market Department staff in training courses, seminars (letter No. (7.31-04)-19K-S0551) of November 9, 2006).
Seeking to ensure the efficient	Address in written IT Department	Letter No. (7.31-04) 19K-S0513 of

and safe use of all data used in Financial Markets Department we recommend to address IT Department in order to provide information modification, erasing and/or entering rights only to those users who are responsible for this information.	with request to provide respectful employees with information modification, erasing and/or entering rights.	October 24, 2006.. Employees of the Financial Services Division received rights of information modification, erasing and/or entering.
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Source: Internal Audit Service of the Ministry of Finance