Lithuania

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The economic downturn last year was among the mildest in the EU, and the recovery in 2021 has been surprisingly strong. The worsening of public finances, expected to be temporary, has been more in line with country risk peers. Higher than previously expected EU funding has improved the medium-term growth prospects. Longer-term challenges include the demographic outlook.

Country Risk Analysis

Recent economic developments

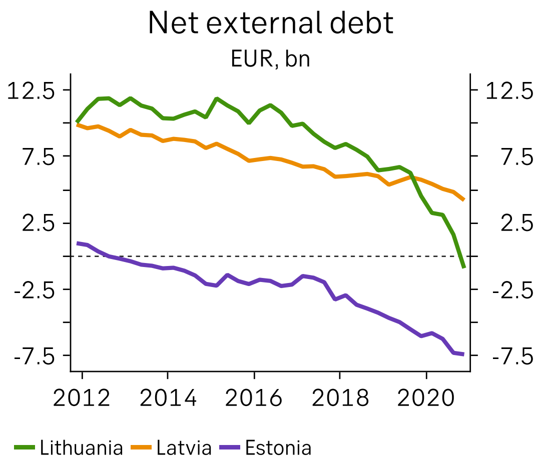
Resilient during the global downturn. The economy entered the pandemic in a relatively strong position. Fiscal and external balances were strong while households and corporate balance sheets were in a much better shape than at the onset of the global financial crisis. This, together with supportive policies and the fact that tourism and travel makes up a relatively small share of the economy, helped limit the economic downturn. The 0.9% contraction in GDP last year was among the mildest in the EU. Economic activity in 2021 has so far recovered more quickly than we had been expecting, helped by a strong performance in the manufacturing industry. Real GDP rose by 1% yoy in the first quarter, according to the first estimate, thereby lifting the size of the economy above its pre-pandemic level.

A continued rise in net migration eases demographic challenge. The cooling economic activity was reflected in a relatively modest rise in the unemployment rate to 8.5% (from 6.3%). It is now likely to have peaked. The rise in unemployment comes against a background of a small increase in the labour supply. Preliminary data indicate a small rise in the population last year, following a long period of declines. The rise is much due to a significant increase in net migration. However, the decline in the working age population is not likely to be stopped.

Still rapid wage growth. Wages in Lithuania are normally sensitive to cyclical changes affecting the unemployment rate. However, the past year's relatively modest rise in unemployment did little to dampen the pace of wage hikes. Average wages and salaries rose by 10.1% (8.8% in 2019) led by public sector wage hikes. The development extends a long period under which wage growth has surpassed productivity growth, and serves as a reminder of the risk of losing cost competitiveness. This being said, average nominal wages are still among the lowest in the EU.

Muted inflation is picking up. Rapid wage hikes normally pass through to services prices which then tend to drive overall inflation. However, falling energy prices contributed to a decline in average inflation to 1.1% in 2020. In 2021, headline inflation has picked up, in line with developments in the euro area.

External finances continued to strengthen. Exports proved resilient to the global downturn. Pharmaceuticals and computer services were among the products that helped keep overall volumes broadly unchanged compared to 2019. This helped to lift the current account surplus to 8% of GDP. An extended trend of surpluses does not signal any decline in competitiveness. On the contrary, the country continued to gain global export markets shares in 2020 at an even faster pace than previous years. Gross external debt edged up last year as the government increased its borrowings. In net terms, however, Lithuania became an external creditor, and of the same magnitude as most country risk peers compared to GDP.



Source: ECB (European Central Bank), Macrobond

Banking sector posing limited contingent liabilities. The banking sector is dominated by the Nordic banks implying limited contingent liabilities for the government. The sector is highly concentrated. The share of non-resident deposits is marginal, reducing parts of the risks of AML/CTF irregularities.

Economic policies

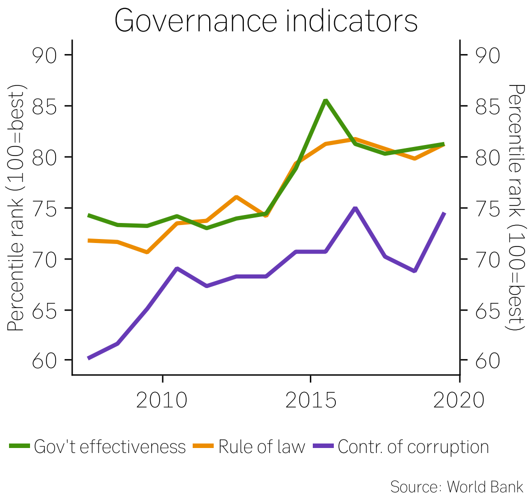
Streak of government budget surpluses interrupted. The country's strong fiscal position and solid track record of effective fiscal policy is a key factor reducing country risk. It also gave the government ample room to respond to the downturn. Spending to milden the downturn, and the workings of automatic stabilisers, caused a general government deficit of 7.4% of GDP in 2020. The government's short-term work programme was among the single largest support measures.

Low government revenues limit room for manoeuvre. Government revenues as a share of GDP, at about 33%, is among the lowest in the EU, despite measures taken to improve tax collection over the past few years. This limits the government's flexibility in meeting spending requirements. A relatively large informal sector and tax avoidance are among the main reasons for the low revenues.

Higher government debt in 2020-2021. After edging up already in 2019 (due to the pre-financing of debt redemptions), general government debt rose sharply to 47.1% of GDP last year, an all-time high. The rise was broadly in line with that of other countries at similar levels of country risk, and the level is still slightly lower than average among peers. The ECB's bond buying schemes contributed to very favourable financing conditions. This has helped to keep debt affordability metrics at stronger levels than most peers, despite the low revenues.

Economic and institutional structures

Strong institutions and governance. Lithuania has a strong and independent institutional framework. This is, for example, reflected in the World Economic Forum's index measuring institutional quality where the country ranks 34 of 141 economies. It thereby ranks ahead of most country risk peers but after for example Estonia. Most World Bank governance indicators are stronger than average among peers, although the control of corruption is somewhat weaker. Moreover, the business climate is favourable, reflected for instance in the World Bank's Ease of Doing Business index, were Lithuania leads most country risk peers.



Per capita incomes roughly in line with peers. GDP per capita, measured at market exchange rates, is broadly in line with the average of country risk peers. For example, the country lags the Czech Republic and Malta but leads Poland. Adjusted for purchasing power, GDP per capita as a share of average in the EU rose to 83% in 2019.

Sovereign credit rating improved. Following sovereign credit rating upgrades by two of the major rating agencies in early 2020, the third major agency upgraded the sovereign's credit rating in early 2021. The agency motivated the upgrade by, firstly strong medium-term growth prospects supported by EU funding and secondly, expectations that government debt will remain lower than most sovereign peers and that debt affordability will remain strong. The reasoning mainly has a bearing on sovereign credit worthiness but is relevant for our measure of country risk too.

Political developments

Political and security risks are limited… Lithuania has seen frequent changes in the governing coalition over the past few years. A new center-right coalition government started its work in December 2020. The coalition led by Prime Minister Simonyte, a former finance minister, has 74 seats together in the 141 seat parliament. Policy-wise the government's main thrust is likely to remain broadly unchanged, including prudent fiscal policy, nurturing ties to the EU and NATO, and safeguarding a favourable business climate.

…mainly lifted by the regional security situation. Tensions with Russia have remained high ever since the country's intensified conflict with Ukraine in 2014. Sanctions introduced at the time triggered a decline in the share of exports to Russia, from 21% to about 13% last year. The share of import has fallen too. In the past year, tensions have also increased with neighbouring Belarus. On energy security, the supply from other sources than Russia have risen over the past few years. In 2021, the expected completion of a gas pipeline to Poland will connect the Baltic region to the EU's gas network which should further improve energy security in the region.

Outlook

Growth forecasts raised. Economic activity in 2021 has so far recovered more quickly than we had been expecting, helped by strong performance in the manufacturing industry. In addition, the pace of vaccinations has proceeded at a swift rate compared to the rest of the EU. This leads SEB to raise our growth forecast for 2021 to 4.5%. In 2022 we expect the economy to grow 3.8%. This being said, the forecasts are attached with a high degree of uncertainty given the uncertain development of the pandemic and measures to handle it.

Wage growth to ease slightly while overall inflation should pick up. Despite a slightly more accelerated economic recovery, the unemployment rate should remain largely unchanged in 2021 while inflation picks up, fuelled by rising energy prices. Wage increases, on the other hand, should moderate although not as much as previously forecasted.

Medium-term growth to be supported by EU funded investment. For years, the vast majority of public investment activity has been financed by EU funds. This has been an important fuel for growth. Contrary to previous expectations of lower EU funding going ahead, the Next Generation EU (NGEU) recovery financing package and the new medium-term financing framework is expected to lead to Lithuania receiving higher amounts of loans and grants over the next few years. This should boost public investment during these years and, provided that they are wisely invested, could also help lift longer-term productivity and growth. Some current estimates put potential, long-term growth at a relatively dismal 1.5%.

Continued fiscal support in near-term. With pandemic restrictions still in place, fiscal support measures are likely to be scaled down only very gradually. The general government deficit is expected to remain broadly unchanged in 2021 and may not reach below the Maastricht 3% of GDP level until 2023. As a consequence, the government debt ratio should rise to about 50% of GDP this year. Following some stabilization in 2022, the medium-term trend should be downward. Meanwhile, debt affordability should continue to improve, already in the near-term, as the last bonds (USD denominated and relatively expensive) issued following the global financial crisis will mature in 2021-2022.

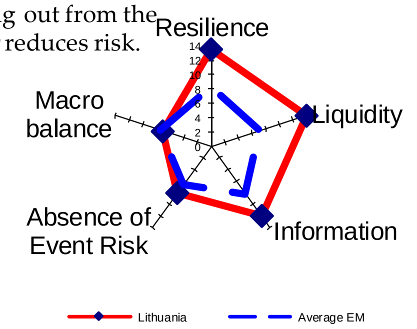
Demographic structure implies risks to growth, competitiveness and government finances. Following the halted decline in the overall population last year, most forecasts point to a continued decline. In particular, forecasts from for example the United Nations project the working age population to shrink by about 25% over the coming two decades. First, a shrinking working age population requires that the labour force is used more efficiently in the production of goods and services. Otherwise growth declines (all else equal). Second, if the lack of skilled labour leads to a continued wage-productivity gap there is a risk that the economy's competitiveness will suffer. Third, the projected rise in ratio of elderly to the working age population (dependency ratio) could be among the most marked in the EU. This is likely to put pressures on the pension system and government finances. The authorities have taken several mitigating measures in the past few years.

Size and openness of the economy implies risks from external developments. With exports making up roughly 80% of GDP, Lithuania's openness and small size makes growth vulnerable to fluctuations in foreign demand and security, in particular in Europe and Russia. A separate risk to the large and externally focussed transport sector, normally standing for nearly two thirds of services exports, relates to changes in EU legislation in the so called mobility package. The final legislation is still subject to legal proceedings but could imply important curbs to the transport business.

Lithuania: Risk Profile

Key ratios	**2021**
Population (mn.)	2,8
GDP/capita (USD)	22327
GDP (% change)	4,6
Inflation	2,6%
Current account balance/GDP	3,7%
Reserves/imports (months)	1,4
Budget balance/GDP	-7,3%
Government debt/GDP	50,2%

How to read the chart?
Moving out from the center reduces risk.



External ratings:
Fitch: A (sta)
Moodys: A2 (sta)
S&P: A+ (sta)

Peers:
Poland
Slovenia
Czech Republic

Graph: Lithuania's risk profile is strong on resilience, and liquidity and relatively weaker on the absence of event risk.

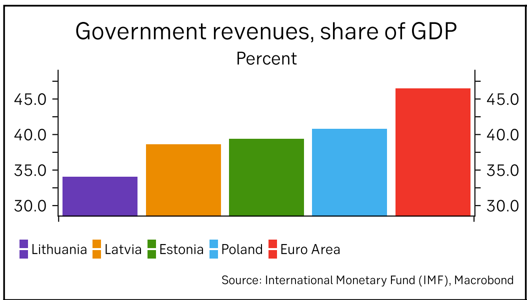
Lithuania: Key Economic Indicators

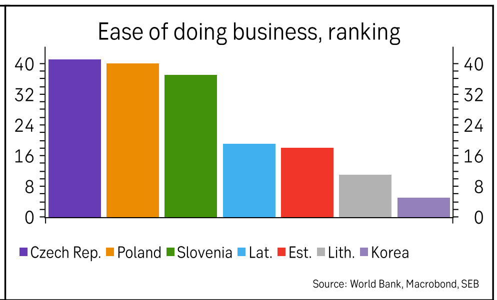
Macroeconomic	2017	2018	2019	2020	2021	2022	2023	2024
GDP (USD bn)	47,7	53,7	54,6	55,7	61,6	66,2	70,4	74,2
GDP/capita (USD)	16992	19225	19551	19906	22327	24217	26005	27680
GDP (change)	4,4%	3,9%	4,3%	-0,9%	4,6%	3,8%	2,8%	1,9%
Investments/GDP	21%	22%	22%	22%	23%	23%	23%	24%
Trade/GDP	141%	133%	141%	133%	132%	131%	127%	123%
Government finances								
Budget balance/GDP	0,5%	0,6%	0,5%	-7,4%	-7,3%	-4,5%	-0,9%	-0,8%
Govt debt/GDP	39,4%	34,2%	36,3%	47,1%	50,2%	51,3%	45,6%	43,2%
Prices and money								
CPI inflation (%)	3,7	2,7	2,2	1,1	2,6	2,6	2,3	2,2
Money, M2 (% change yoy)	10	10	10	12	10	10	9	9
Interest rates	-0,3%	-0,3%	-0,4%	-0,4%	-0,5%	-0,4%	-0,4%	-0,3%
Exchange rate (USD)	0,9	0,8	0,9	0,9	0,8	0,8	0,8	0,8
Oil price (Brent, USD)	54	71	64	42	67	62	60	61
Balance of payments (USD, bn)								
Export of goods	33,9	36,2	39,7	39,1	41,5	43,3	44,6	45,5
Imports of goods	33,3	35,4	37,6	35,2	39,6	43,2	44,7	45,7
Other current account flows	-0,3	-0,7	-0,2	0,5	0,4	1,3	0,8	0,6
Current account	0,3	0,2	1,8	4,4	2,3	1,4	0,7	0,4
(% of GDP)	0,5	0,3	3,3	8,0	3,7	2,1	0,9	0,5
FDI	0,9	0,3	1,0	0,6	0,6	0,7	0,7	0,8
Loan repayments (USD, mn)	9,3	9,7	8,5	10,3	11,7	12,4	13,1	13,6
Change in int. reserves	1,8	1,3	-0,8	-0,4	0,9	0,2	0,2	0,2
External debt and liquidity (USD bn)								
Reserves	4,0	5,3	4,5	4,2	5,1	5,3	5,4	5,6
Total debt	41,2	40,6	36,6	45,7	51,0	54,4	57,1	59,0
o/w short term debt	6,2	6,2	5,6	6,9	7,7	8,3	8,7	8,9

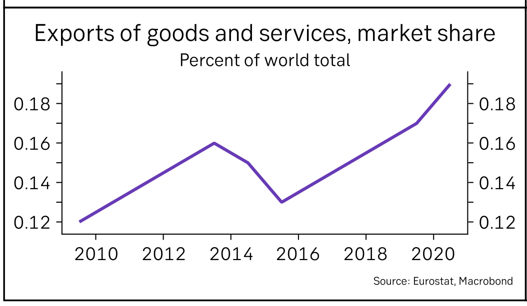
Source: Oxford Economics and SEB

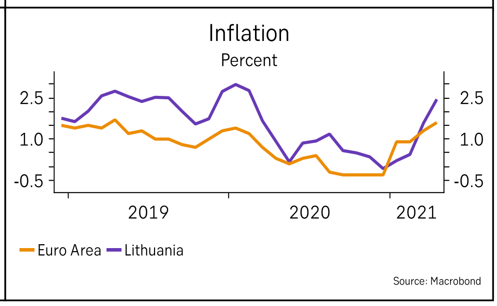
Rating history				
Fitch (eoy)	A-	A-	A-	A-
Moodys	Baa1	A3	A3	A3

Type of government:	Parliamentary Democracy
Next elections	Parliamentary elections: October 2024. Presidential elections: May 2024
Other:	
Latest PC deal	None
Latest IMF arrangements	SBA 2001









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