Lithuania

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A long track record of fiscal prudence and a strong institutional framework should allow the government to respond to the current economic shock without worsening its over-the-cycle credit metrics. Medium-term challenges include the demographic outlook.

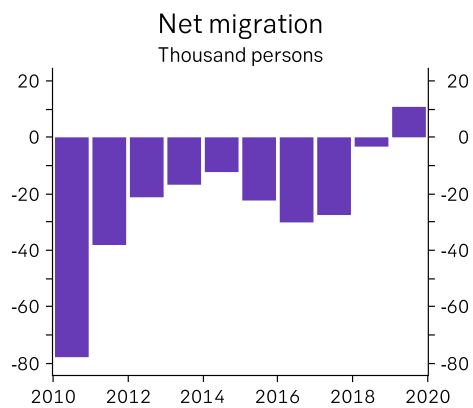
Country Risk Analysis

Recent economic developments

Growth remained surprisingly strong in 2019. Economic growth surprise most analysts last year when it edged up to 3.9% boosted by strong household spending and rising exports. In the second half of the year, however, the cooling global economy started to take its toll on exports, and growth slowed. The first estimate of Q1 GDP 2020 showed the economy still growing at 2.5% in yoy terms, thanks to a strong performance in the first two months. More recent data reflect a sharp contraction across the economy.

Labour market conditions remained tight. The above potential economic growth last year was reflected in continued relatively tight labour market conditions. Although the unemployment rate edged up to 6.4% it was low by historical standards. Meanwhile, the employment rate rose. Unemployment has continued to edge up in the first months of 2020.

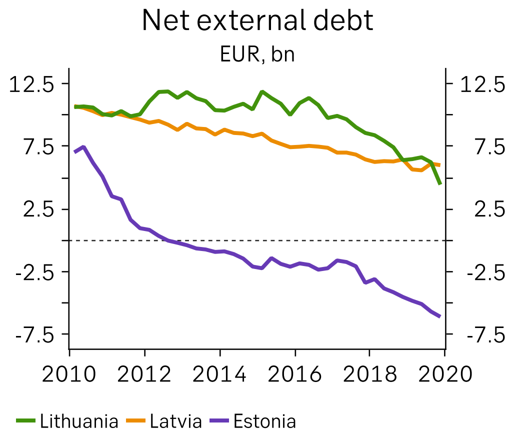
Positive net migration. Labour shortages were to some degree alleviated by net migration turning positive in 2019 for the first time in decades. This was driven by the return of Lithuanians and immigration from mainly Ukraine and Belarus. In business surveys, fewer and fewer firms report that lack of labour is a constraint on production. The improved migration balance also contributed to halting the decline in the overall population last year. However, the decline in the working age population is not likely to be stopped.



Source: Statistics Lithuania, Macrobond, SEB

Tight labour market conditions boosted wages but inflation is moderating. Labour shortages was reflected in rising labour costs. Average wages and salaries rose by 8.8% in 2019, slightly less than in 2018, despite hikes in minimum and public sector wages. Rapid wage hikes normally passes through to services prices which tend to be the main drivers of inflation. However, average overall inflation declined to 2.2% in 2019. In 2020, headline inflation has dropped in line with developments in the euro area.

Stronger external balances. The past years rapid economic growth have so far not fuelled any major external imbalances. This contrasts sharply to the period of fast economic growth leading up to the global financial crisis. The current account which has showed a small surplus on average in the past five years, recorded a rising surplus of nearly 4% of GDP in 2019. The past year's export performance has been solid, despite slowing global demand and hence does not signal a decline in competitiveness. Unlike most countries in higher country risk classes, Lithuania's net international investment position is negative and it remains a net debtor. Net debt, however, is expected to continue on a downward path.



Source: ECB (European Central Bank), Macrobond

Economic policies

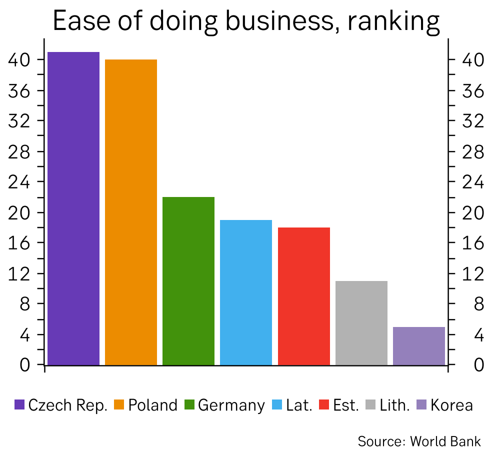
Strong fiscal position temporarily weakened. The country's strong fiscal position and solid track record is a key factor reducing country risk. It also gives the government ample room to respond to the current downturn. Measures taken to dampen the ongoing shock and the impact of automatic stabilisers will shift the budget balances into negative to the tune of at least 9.5% of GDP in 2020 and spill over to a deficit of 3.5% in 2021. The country has very low government revenues in relation to GDP relative to other EU countries, around 35%, despite efforts to improve tax administration and compliance. This is partly a consequence of a relatively large informal sector.

Government less indebted than peers. Public debt has been on a steady downward trend since 2015. Last year, however, general government debt as a share of GDP rose to 36.3% according to Eurostat as the government pre-financed debt redemptions due in 2020. This is still lower than average among economies at a similar level of country risk. The average maturity of debt has risen and is longer than average in the euro area. To finance this year's increased spending, the government has increased its net borrowing limit by the equivalent of more than 12% of GDP. Unlike during the 2009 economic downturn, the country is a euro area member which together with the current market environment will provide for more favourable financing conditions.

Banking sector posing limited contingent liabilities. The financial system was recently characterised by the IMF as "profitable, well capitalised and liquid with no signs of emerging imbalances". Non-performing loans as a share of total has edged down in the past years and reached long-term lows in 2019. The banking sector is dominated by the Nordic banks implying limited contingent liabilities for the government. It also causes a high degree of concentration, which has risen.

Economic and institutional structures

Strong institutions and governance. Lithuania has a track record of a strong and independent institutional framework, including for fiscal policy and financial supervision. As an illustration, Lithuania last year advanced to 34 of 141 economies in the World Economic Forum's index measuring institutional quality. This puts the country ahead of most country risk peers but after for example Estonia. Most World Bank governance indicators are stronger than average among peers. Moreover, the business climate is favourable, reflected in the World Bank's Ease of Doing Business index, where the country recently rose to rank 11 of 190 countries, leading most peers. The relatively large shadow economy, on the other hand, remains a weakness when we assess the economy's resilience.



Per capita incomes have picked up. Measured at market exchange rates, GDP per capita has increased over the past decade and is broadly in line with the average of peers at a similar level of country risk.

Rating agencies improved ratings and outlook. In early 2020, two of the major rating agencies upgraded the sovereign's credit rating. The agencies argued that growth in GDP and per capita incomes had been positive, that government debt had developed favourably and that their confidence in the policy framework had increased. In mid-2019, another of the rating agencies introduced a positive outlook to their sovereign rating, pointing to a continued improvement in the fiscal strength and improving prospects for medium and long-term growth potential. Most of the agencies' reasoning are relevant for country risk too. However, the improvement in a range of country risk indicators over the past few years are now temporarily overshadowed by the large uncertainty brought on by the corona crisis.

Political developments

Parliamentary elections due in October. Lithuania has seen frequent changes in the governing coalition over the past few years. In mid-2019, a new coalition government consisting of four parties was agreed. It is led by Saulius Skvernelis of the Lithuanian Farmers and Greens Union. Parliamentary elections are due in October 2020. They are not expected to lead to any fundamental policy shift. Most parties support reasonably prudent fiscal policy, continued close ties to the EU and NATO, and a favourable business climate.

Geopolitical risk remains important. Tensions with Russia have remained high ever since the country's intensified conflict with Ukraine in 2014. Although an outright military intervention by Russia should be considered a tail risk event, other forms of interference that has the potential to destabilize the economy such as cyberattacks are more likely. This raises overall political risk.

Outlook

Near-term slowdown not as deep as 2009 crash. With the coronavirus shock hitting the already slowing economy, GDP is expected contract 8.7% in 2020. The IMF and the EU Commission forecast a close to 8% contraction and a V-shaped recovery. As evident, expectations generally are for a slowdown that is significantly less severe than the crash in 2009. Most observers expect a strong rebound in 2021. In the medium-term, growth should settle at rates in line with potential growth, provided that the authorities take adequate measures to limit the negative effects of the declining population. This will continue to yield some further convergence in incomes per capita towards EU averages.

Inflation and wage pressures to ease in short-term. The sharp fall in economic activity should contribute to a cooling of the labour market with the average unemployment rate expected to rise to 9.9% in 2020. Compared to other European countries, wages are very sensitive to cyclical changes affecting the unemployment rate. Accordingly, the higher unemployment is expected to result in wages staying broadly unchanged. Meanwhile, inflation should average less than 1%.

Healthy fiscal position in the medium-term… Following an expected rise in the government debt ratio to almost 50% of GDP this year, the medium-term trend should be downward. Furthermore, the last bonds issued at relatively hefty costs following the global financial crisis are set to mature in 2022. This should lead to falling interest rate costs for the government, improving its already high debt sustainability further.

…despite pressures from lower EU funds and aging population. Although public finances are expected to remain strong, there will be medium-term challenges coming both from the revenue side and from the expenditure side. On the revenue side, the flow of EU funds are likely to decline due to a smaller overall budget and due to Lithuania's rising income level. While negotiations on the Union's next multiannual financing framework (2021-2017) are ongoing, disbursements under the current budget continues until 2022. On the expenditure side, costs related to the rapidly aging population are, like in most European economies, expected to rise. The increase in the old age dependency ratio is forecasted to be among the most marked in the EU.

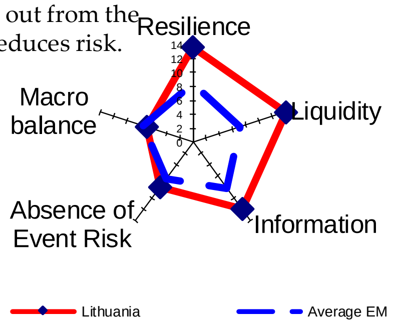
Small open economy vulnerable to adverse external developments. With exports making up roughly 80% of GDP, Lithuania's openness and small size makes growth vulnerable to fluctuations in foreign demand and security, in particular in Europe and Russia. A particularly vulnerable sector of the economy is the large and externally focussed transport sector which also has been an important driver of economic growth in the past few years. Should growth in the eurozone not rebound in the order of 6% in 2021 as we expect, this will weigh on Lithuania's exports and hence its ability to bounce back.

Loss of competitiveness remains long-standing risk. Should future wage increases lead to increases in labour costs that surpass productivity growth for an extended period, the economy risks losing competitiveness.

Lithuania: Risk Profile

Key ratios	**2020**
Population (mn.)	2,8
GDP/capita (USD)	18975
GDP (% change)	-8,7%
Inflation	0,8%
Current account balance/GDP	0,6%
Reserves/imports (months)	1,4
Budget balance/GDP	-9,5%
Government debt/GDP	50%

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



External ratings:
Fitch: A (sta)
Moodys: A3 (pos)
S&P: A (sta)

Peers:
Poland
Estonia
Czech Republic

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

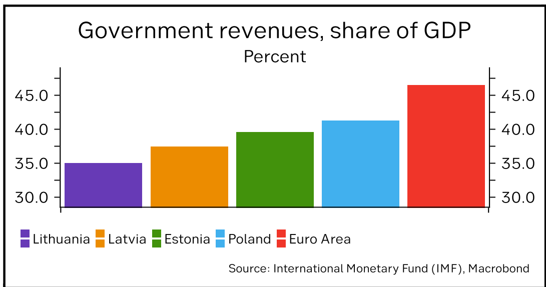
Lithuania: Key Economic Indicators

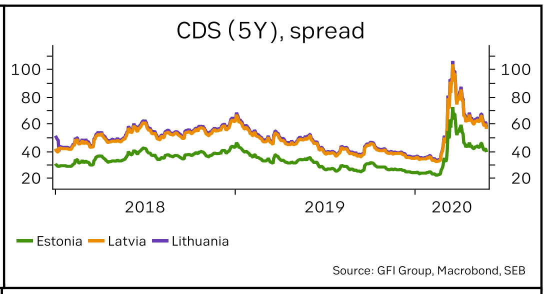
Macroeconomic	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
GDP (USD bn)	43	48	53	54	52	56	61	67
GDP/capita (USD)	15100	17006	19141	19393	18975	20543	22618	24789
GDP (change)	2,4%	4,4%	3,6%	3,9%	-8,7%	6,1%	3,0%	2,3%
Investments/GDP	20%	21%	21%	22%	22%	23%	23%	24%
Trade/GDP (%)	139%	141%	134%	143%	139%	138%	130%	123%
Government finances								
Budget balance/GDP	0,3%	0,5%	0,6%	0,3%	-9,5%	-3,5%	-0,4%	-0,2%
Govt debt/GDP	40,1%	39,4%	34,2%	36,3%	49,5%	51,5%	49,0%	34,0%
Prices and money								
CPI inflation (%)	0,9%	3,7%	2,7%	2,3%	0,8%	2,2%	2,4%	2,2%
Money demand (%)	70%	71%	78%	87%	84%	49%	47%	45%
Interest rates	0,1%	0,1%	0,1%	0,0%	0,0%	0,0%	0,1%	0,4%
Exchange rate (USD)	0,9	0,9	0,8	0,9	0,9	0,9	0,9	0,9
Oil price (Brent)	$44	$54	$71	$64	$38	$44	$49	$53
Balance of payments (USD, bn)								
Export of goods	29,9	33,9	36,1	39,5	37,0	39,4	40,5	41,6
Imports of goods	29,9	33,5	35,5	37,9	35,8	38,3	39,4	40,6
Other:	-0,5	-0,2	-0,4	0,5	-0,9	-0,9	-0,8	-0,9
Current account	-0,5	0,2	0,2	2,0	0,3	0,2	0,2	0,1
as % of GDP	-1,1%	0,5%	0,3%	3,8%	0,6%	0,4%	0,3%	0,1%
FDI	0,2	0,6	0,1	0,9	0,3	0,3	0,4	0,4
Loan repayments (USD, mn)	-8,1	-9,6	-9,7	-8,6	-8,4	-8,7	-9,5	-10,4
Net other capital flows (USD, mn)	4,5	5,0	6,8	2,5	4,3	11,9	12,0	11,4
Balance of payments	-3,9	-3,7	-2,7	-3,1	-3,4	3,8	3,1	1,4
External debt and liquidity (USD bn)								
Reserves	2,2	4,0	5,3	4,5	4,9	5,1	5,3	5,4
Total debt	35,3	42,5	40,7	36,9	36,8	39,0	42,1	45,3
o/w short term debt	5,4	6,5	6,3	5,7	5,7	6,0	6,5	7,0

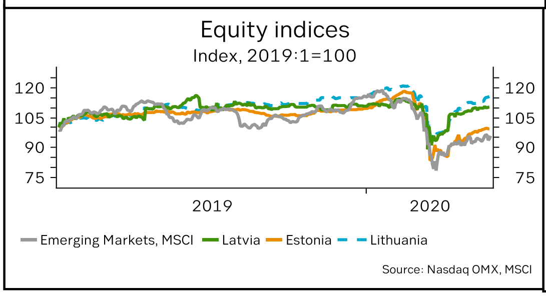
Source: Oxford Economics and SEB estimates

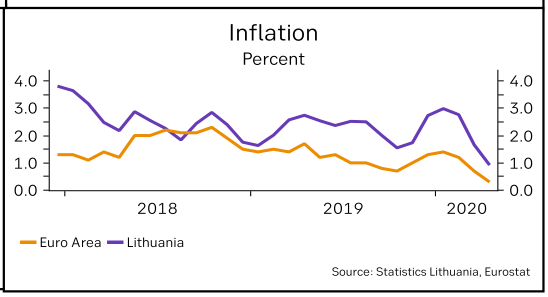
Rating history				
Fitch (eoy)	A-	A-	A-	A-
Moodys	Baa1	A3	A3	A3

Type of government:	Parliamentary Democracy
Next elections	Parliamentary elections: October 2020. Presidential elections: 2024
Other:	
Latest PC deal	None
Latest IMF arrangements	SBA 2001









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