Lithuania

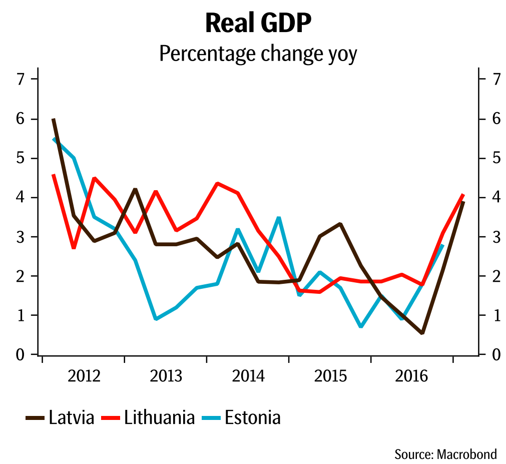
Analyst: Martin Carlens. Tel: +46 8-763 96 05. E-mail: Martin.carlens@seb.se

Economic growth has been held back by low investment due to lower EU funding but is picking up speed. Conditions in the labour market are improving, leading to steadily higher labour costs and prompting many observers to caution against a possible loss of competitiveness. Meanwhile, some positive policy measures are being taken to deal with the challenges posed by the shrinking and ageing population.

Country Risk Analysis

Recent economic developments

Economy picking up speed. Household spending fuelled by continued rapid wage increases and since long the main growth engine of the economy, lifted GDP by 2.2% in 2016. Although this is not as much as we had expected it is nonetheless an acceleration from 1.8% in the previous year. Investment activity fell, largely depending on the timing of EU structural funds disbursements, a key cyclical feature seen across Eastern Europe. The first estimates of GDP growth in the first quarter of 2017 indicate accelerating growth.



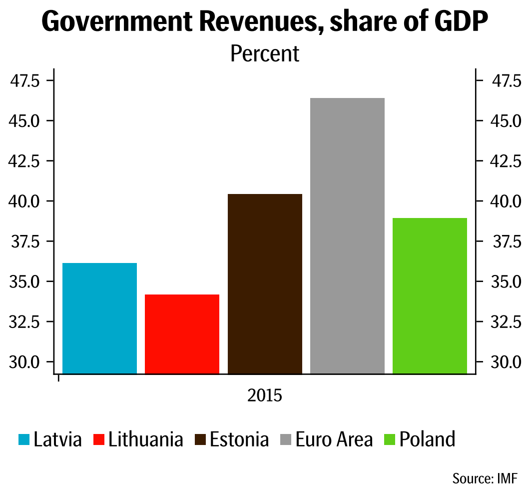
Continued improvements seen in the labour market. Conditions in the labour market continued to improve last year with unemployment declining to 7.9%, significantly below the average of the past 10 years. A rising temperature in the labour market was reflected in rising labour cost. Following two hikes in minimum wages in 2016, overall wage growth (nearly 7% in real terms) has surpassed productivity growth every year since 2012. In other words, unit labour costs (ULC) have been rising. Observers such as the IMF and the EU Commission conclude that although Lithuania has one of the lowest ratios of labour income to national income in the EU, the high wage growth is increasingly becoming a challenge to the country's competitiveness.

Inflation picking up. Despite rapid wage increases, inflation was just 0.9% in 2016, which was only slightly higher than the euro area. More recently, inflation has accelerated, in line with developments in the other Baltic economies and hit 3.5% in April 2017.

Current account temporarily shifts into positive territory. Lithuania's exports have been recovering but volumes are still lower than during the rebound following the global financial crisis. However, with imports being even lower in 2016 due to declining investment activity there was an improvement in the trade balance. This in turn lifted the current account into a marginal surplus from last year's -2.6% of GDP. The balance is expected to swing back into a deficit in the near-term as investment activity picks up. The financing of the deficit should be manageable also going ahead, despite some possible decline in remittances from the UK, as foreign direct investment (FDI) and EU funds are expected to remain at healthy levels. External debt edged up to 86% of GDP in 2016. Most of this debt is held by the government and central bank.

Economic policies

Fiscal position remains strong. The country's strong fiscal position and track record is a key factor reducing country risk. The general government budget balances turned out better than expected last year, showing only a marginal deficit compared to the budgeted -1.2% of GDP. This was an improvement compared to 2015 and was driven by strong revenues helped by government efforts to bring activity in the grey sector into the formal economy. Although progress is made to improve tax collection Lithuania still has one of the lowest revenue to GDP ratios in the EU. For 2017, higher pension and defence spending (targeting 2.4% of GDP by 2018) may lift the deficit slightly contrary to a balanced budget originally planned by the previous government.



Near-term costs for package of reforms in "new social model". The budget includes the costs related to the set of reforms collectively called "new social model" (initiated in 2015). These reforms, some of which were implemented in early 2017, aim to improve the flexibility of the labour market as well as dealing with challenges related to the pension and social security system caused by an ageing and shrinking population. Although the government expects the package of reforms to generate longer term fiscal savings and increases in employment, they estimate near-term costs equivalent to 0.5% of GDP, according to FitchRatings. While the package of reforms have been met with cautious positive comments by most observers, the IMF has suggested some parts ought to be reconsidered.

Government debt at moderate levels. The government debt ratio relative to GDP edged down in 2016 to 40.2%. This is broadly in line with that of other countries in similar risk classes. Although debt may rise slightly in 2017, due to the prefinancing of bond redemptions maturing in 2018, the ratio is expected to be on a downward trend in the medium-term. The maturity structure of the debt is favorable with a small share being short-term.

Banking sector health is improving. The IMF recently noted that financial soundness indicators for the banking sector remain favourable. The sector, dominated by the Nordic institutions, is well capitalised and liquid and the share of non-performing loans is declining (to just above 4%). The expansion in household lending is accelerating with annual credit growth hitting nearly 7% in 2016. This should support economic activity in the near-term.

Political developments

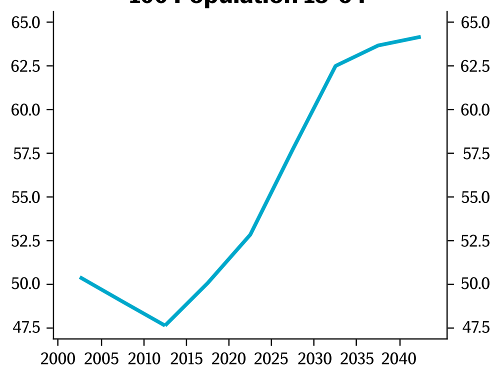
Untested ruling party assumed not to change fundamental political direction. The Peasants and Greens Union (LVZS) won a landslide victory in the October 2016 parliamentary elections. The party is relatively inexperienced and diverse. However, the formation of a new coalition with the Social Democrats (LSDP) that led the previous government should provide some assurance of policy continuity. The coalition has a narrow majority (71 of 141 seats) and some observers see a risk that they may not be able to serve a full term in office. We assume that no major policy shifts will be made and that the government will remain committed to further EU integration, to further strengthening its energy supply and raising defense expenses.

Outlook

In the near-term growth is set to recover, buoyed by continued solid private consumption despite slightly lower growth in real disposable income, and by a continued recovery in private investment as new EU funding becomes available. This should lift GDP growth to roughly 2.5% in 2017. The government expects marginally higher growth. Inflation should be a tad higher than we have previously thought while unemployment should gradually decline. Meanwhile, the current account balances should swing into negative territory again as domestic demand will remain strong.

Risks related to size of economy and to competitiveness. The openness and small size of the economy makes growth vulnerable to fluctuations in demand and security, in particular in Europe and Russia. Shocks to imports or exports could easily translate into slower growth and a wider current account deficit.

Ratio of Population Aged 0-14 & 65+ per 100 Population 15-64



Source: United Nations

Furthermore, Lithuania (and its northern Baltic neighbours) has one of the most adverse demographics among European countries. A shrinking population requires that the labour force is used more efficiently, especially as wage growth is expected to remain high. Otherwise, competitiveness would suffer leading to lower economic growth in the longer run.

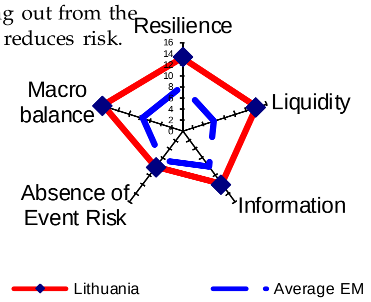
In addition, the rising ratio of elderly to the working age population will soon put pressures on the pension system and government finances. In this context, the measures included in the "new social model" package should be a mitigating factor.

A worsening of the regional geopolitical tensions is a risk. Although Lithuania benefits from a recently stepped up military commitment from NATO, geopolitical risk in the region remains elevated. While this is weighed into the proposed risk class, there is a risk that tensions involving Russia could worsen. This being said, unlike Estonia, Lithuania does not share a border with Russia and Lithuania has a smaller share of ethnic Russians than Latvia.

Lithuania: Risk Profile

Key ratios	2017
Population (mn.)	2.4
GDP/capita (USD)	15776
GDP (%chg.)	3.2%
Inflation	3.3%
Curr.Acc. Balance/GDP	-2.2%
Reserves/imports (months)	0.6
Budget balance/GDP	-0.5%
Government debt/GDP	36%

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



External ratings:
Fitch: A-
Moodys: A3
S&P: A-.

Peers:
Estonia
Malaysia
Latvia

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

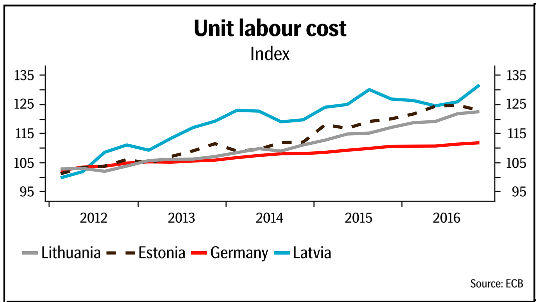
Lithuania: Key Economic Indicators

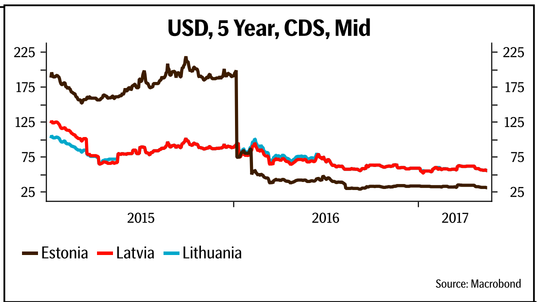
Key data:	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
GDP (USD bn)	26	28	34	35	37	39	40	42
GDP/capita (USD)	15700	16664	14418	15119	15776	17195	18615	20145
GDP (change)	3.5%	3.5%	1.8%	2.2%	3.2%	3.0%	3.2%	3.0%
Investments/GDP	19%	19%	20%	19%	20%	20%	20%	20%
Budget balance/GDP	-2.6%	-0.7%	-1.5%	-0.2%	-0.5%	-0.6%	-0.5%	-0.5%
Govt debt/GDP	39%	41%	43%	38%	36%	34%	33%	31%
CPI inflation (%)	1.0%	0.1%	-0.9%	0.7%	3.3%	2.8%	2.0%	2.0%
Money demand (%)	19%	14%	41%	45%	50%	19%	17%	17%
Stock prices (%change)	17%	25%	-3%	14%	15%	34%	13%	24%
Interest rates	0.1%	0.1%	0.0%	0.1%	-0.3%	-0.3%	-0.1%	0.1%
Exch. Rate (USD)	1.3	1.3	1.1	1.1	1.1	1.1	1.1	1.1
Trade/GDP (%)	257%	254%	214%	212%	207%	209%	209%	210%
Oil price (Brent)	$99	$52	$44	$52	$52	$59	$68	$75
USD, bn.								
Export of goods	34.5	35.6	35.5	36.6	38.0	39.8	41.5	43.3
Imports of goods	33.3	34.4	36.6	37.5	39.3	41.2	43.1	45.0
Other:	-0.4	0.5	0.1	1.1	0.4	0.4	0.4	0.4
Current account	0.7	1.7	-1.0	0.1	-0.8	-1.1	-1.1	-1.2
as % of GDP	2.7%	6.4%	-2.9%	0.4%	-2.2%	-2.7%	-2.8%	-3.0%
FDI	0.3	0.0	0.8	1.0	1.0	1.1	1.2	1.3
Loan repayments (USD, mn)	-5.2	-5.0	-6.1	-6.2	-6.5	-6.5	-6.7	-6.9
Net other capital flows (USD, mn)	5.7	3.8	-0.4	-0.4	0.0	7.8	7.8	8.9
Balance of payments	1.5	0.6	-6.7	-5.4	-6.2	1.4	1.2	2.1
Reserves	7.6	8.3	1.3	2.2	2.1	2.7	3.4	4.2
Total debt	31.8	30.4	31.2	31.9	32.8	34.0	35.5	37.4
o/w short term debt	5.4	5.1	5.3	5.4	5.5	5.7	6.0	6.3

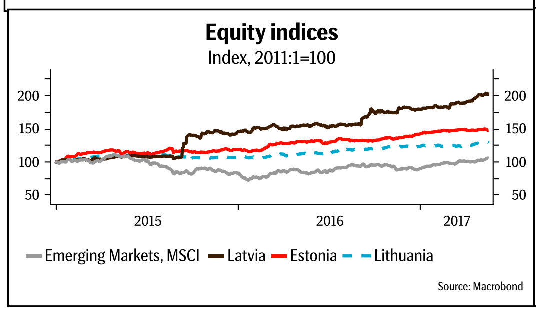
Source: OEF (Oxford Economic Forecasting) and SEB estimates

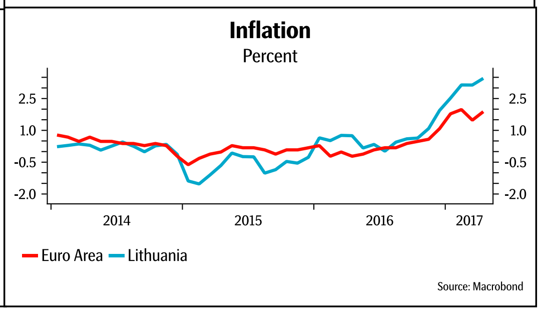
Rating history				
Fitch (eoy)	BBB+	BBB	BBB	A-
Moodys	A2	Baa1	Baa1	Baa1

Type of government:	Parliamentary Democracy
Next elections	Parliamentary elections: October 2020. Presidential elections: May 2019
Other:	
Latest PC deal	None
Latest IMF arrangements	SBA 2001









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