LITHUANIA

Highlights

- **Lithuania's growth has been resilient.** The corporate sector managed to withstand the fallout from the Russian recession and sanctions regime relatively well. Domestic demand continues to be the main engine for growth, primarily on the back of an improving labour market situation, continued real wage increases and decreasing oil and other commodity prices.
- **Lithuania's eurozone accession in January 2015 has enhanced the credibility of macroeconomic policy.** Common standards of supervision and potential liquidity support within the banking union will further reduce financial system risk.
- **Small and medium-sized enterprises' (SMEs') competitiveness, innovation and energy security are key priorities for the new European Union (EU) operational programme for Structural Funds**. From this multi-fund operational programme, approved in September 2014 and operating from 2014 to 2020, about €6.7 billion will be allocated, some of which will be leveraged through financial instruments.

Key priorities for 2016

- **Efforts to promote innovation should be stepped up**. Lithuania continues to lag behind the EU average in various indicators of innovation performance. Risk capital such as private equity and venture capital need to be further developed, and infrastructure and regulation should be integrated with those in other markets.
- **A new labour code should make labour relations more flexible and could raise employment rates.** This will need to remain a key area of attention for the government, given that the working age population is projected to decline by 44 per cent between 2013 and 2040, due to ageing and emigration.
- **Lithuania's reliance on imported energy should be reduced.** Domestic generation of electricity produced by renewable sources is low. Investments in local energy production from renewable sources as well as the further integration of the Lithuanian energy market with the rest of the EU are needed.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	6.0	3.8	3.5	3.0	1.7
Inflation (average)	4.1	3.2	1.2	0.2	-0.6
Government balance/GDP	-8.9	-3.1	-2.6	-0.7	-1.5
Current account balance/GDP	-3.9	-1.2	1.5	3.6	-2.0
Net FDI/GDP [neg. sign = inflows]	-3.2	-0.7	-0.6	0.4	0.5
External debt/GDP	75.3	74.9	69.2	61.8	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	49.2	45.8	42.7	40.5	n.a.

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Macroeconomic performance

Lithuania's recent growth has been more balanced and primarily driven by domestic demand. The improving labour market conditions and continued real wage increases have underpinned household consumption in 2014 and the first half of 2015. The contribution of net exports turned negative, primarily due to the significant depreciation of the Russian rouble and counter-sanctions on EU agricultural produce. Exports have held up well in 2014, even as sanctions and economic contraction impacted Lithuania the most relative to other EU member states. This has been attributed to the successful re-orienting of trade to other markets. In 2014, the value of exports of Lithuanian-origin goods to Russia declined by more than 16 per cent compared with the same period in the previous year. Total exports nevertheless increased by 3 per cent in annual terms. On the back of an even more rapid import growth, net trade contributed negatively for the first time since before the crisis.

Banks have remained cautious in lending and enterprises financed large shares of investments from retained earnings. Deleveraging of funds by foreign creditors continued, evidenced by an annual net withdrawal of 7.2 per cent of GDP up to the first quarter of 2015, and corporate credit contracted further by 3 per cent over the same period. In the past two years investment grew strongly partly due to the absorption of EU funds, particularly during 2013-14. The government is focusing on enhancing access to finance by the SMEs and a concrete set of proposals are currently under consideration in the areas of crowd-funding, public and private placement, and a regulatory framework for collective investment funds.

There have been some improvements in the labour market. Unemployment fell to 8.5 per cent in June 2015, although its structural component remains high. Real wages continue to rise, supported by very low inflation and even deflation since the end of 2014. Labour productivity has been growing rapidly in the post-crisis period and currently is the highest in the Baltic region, amounting to almost 75 per cent of the EU average. However, real wages have been rising at a pace well above productivity, posing some risk to competitiveness.

Lithuania became the 19th eurozone member in January 2015. Eurozone membership eliminates remaining currency risk premia in lending, and credit risks resulting from an independent currency regime. The domestic banking system remains predominantly owned by Scandinavian parent banks, and has now gained access to the European Central Bank's (ECB's) liquidity facilities and resolution fund. Standards of supervision have been strengthened within the Single Supervisory Mechanism. In March 2015 the Bank of Lithuania also approved a macroprudential policy strategy that will limit systemic risks.

GDP growth will likely accelerate over the medium term. This year's projected GDP growth rate has been cut to 1.7 per cent as regional tensions continue to weigh on investor confidence and exports. Next year's rate is expected to reach 3 per cent, driven by improving investments and better exports performance as companies manage to reach new markets for goods previously sold to Russia.

Major structural reform developments

Lithuania is one of the least energy-efficient economies in the EU. Energy intensity is twice as high as the EU average. Following the approval of the Energy Efficiency Action Plan in May 2014 and the introduction of a new financing scheme under the Public Investment Development Agency (VIPA) in April 2013, the modernisation of multi-apartment buildings gained momentum in 2014. About 96 per cent of multi-family buildings were constructed before 1993 and most suffer from outdated heating and isolation facilities. The transport sector also remains highly energy intensive, due to low duties on motor fuels that are close to the minimum level set by the EU.

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The strategic gas interconnector with Poland will bring benefits to the whole of the Baltic region. The grant agreement on the strategic Gas Interconnector Poland – Lithuania (GIPL) has been signed. GIPL, which will connect the isolated gas markets of the Baltic states with the gas market of continental Europe, is of major strategic importance to the whole region. The strategic gas interconnector with a total length of more than 500 km will be completed by the end of 2019.

The government's operational programmes under the EU Structural and Investment Funds were approved in September 2014. During the 2007-2013 budget period Lithuania was eligible for up to €6.7 billion in EU funds, 86.5 per cent of which had been absorbed by March 2015. For the budget period that has just begun (2014-2020) €12 billion has been pre-allocated, of which €6.7 billion is designated under Cohesion Policy instruments. Similar to other EU members, Lithuania will need to establish commercial "financial instruments" under the EU funds. The Public Investment Development Agency (VIPA) is an innovative institution which will allocate such commercially oriented funds and will leverage EU structural funds with private investment.

The government has made further efforts to simplify the business environment. Procedures for starting a business have been further eased, as processes for value-added tax collection were accelerated over the last year. At the same time, contract enforcement was also simplified as electronic filing systems for court users were introduced in mid-2013. The World Bank's *Doing Business 2016* report ranks Lithuania 20th globally, one notch higher than the previous year. This still ranks below its Baltic peer – Estonia, although considerably ahead of other countries in central Europe. Nevertheless, there remain concerns over the efficiency of public institutions, in particular regarding procurement practices and the health sector.

The government has approved changes to the labour code. The changes came into force in July 2015 and are aimed at making labour relations more flexible. Lithuanian statutes still provide among the strictest employment protection in the EU. The shadow economy is estimated by the European Commission (EC) to account for about 26 per cent of GDP. The introduction of modern rules for part-time work is expected to raise employment rates. This is particularly important as the working age population is projected to decline by 44 per cent between 2013 and 2040 due to ageing.

The government has launched a "smart specialisation" strategy. The new strategy, launched in June 2015, is expected to improve Lithuania's innovation performance towards the EU's ambitious 2020 goals. Investment in new technologies remains particularly weak. Lithuania remains one of the lowest ranked countries in the *EU Innovation Scoreboard*. Public and private research and development (R&D) total expenditure remains at only 0.9 per cent of GDP, significantly below the Europe 2020 target of 1.9 per cent. Exports of high-tech goods also remain relatively low at only 5.6 per cent of total exports, compared with the EU average of 15.4 per cent.