INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/177

REPUBLIC OF LITHUANIA

2017 ARTICLE IV CONSULTATION—PRESS RELEASE AND STAFF REPORT

June 2017

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with the Republic of Lithuania, the following documents have been released and are included in this package:

- A **Press Release** on the staff report that concluded the Article IV consultation with the Republic of Lithuania.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on May 15, 2017, with the officials of the Republic of Lithuania on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 15, 2017.
- An **Informational Annex** prepared by the IMF staff.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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June 30, 2017

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IMF Executive Board Concludes Article IV Consultation with the Republic of Lithuania

On June 30, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Lithuania, and considered and endorsed the staff appraisal without a meeting.[2]

The economy has been gathering momentum, following sluggish performance in 2015 and most of 2016. Real GDP expanded by 3.9 percent in the first quarter of 2017 after rising by 2.3 percent in 2016. Strong private consumption, on the back of robust wage growth and low inflation that supported purchasing power, has long been a main driver of growth. More recently, exports have also been growing, as the external environment improves and the adverse effects from retaliatory Russian trade sanctions and depreciation of the Russian ruble wane. But gross fixed capital formation has remained weak so far, reflecting the still subdued absorption of European funds.

Building on recent momentum, economic growth should be strong this year rising to 3.2 percent. Improving external conditions and a turnaround in European funds absorption, as well as high capacity utilization, should spur exports and investment. Private consumption will likely remain robust, although some moderation is to be expected as real wages decelerate. Strong domestic demand will pull in imports, leading to a modest deterioration of the trade balance despite improving export prospects. Annual average HICP inflation is set to spike to 3.4 percent this year, because of higher global energy prices and excise tax hikes earlier this year.

The main policy challenge is to reinvigorate income convergence with Western Europe. For it to be sustainable, Lithuania needs to narrow its productivity gap. Further structural reforms are the main lever to make progress, while macroeconomic and financial stability need to be maintained.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

Executive Board Assessment

In concluding the 2017 Article IV consultation with the Republic of Lithuania, Executive Directors endorsed staff's appraisal, as follows:

The emerging cyclical upswing of the economy is welcome, but Lithuania's productivity gap with Western Europe stopped narrowing in the last three years, raising questions about the sustainability of income convergence. To alleviate downside risks to the medium-term growth outlook, it will not only be important to maintain the sound macroeconomic and financial management of the past. Identifying priority structural reforms that promote growth and help realize the government's income equality objective and then pushing ahead with their implementation is now key.

Public finances are vastly improved. A commendable multi-year consolidation effort culminated in the first ever fiscal surplus last year. The public debt ratio declined from its peak in 2015 to some 40 percent. A package of social measures will push the fiscal balance into a deficit in 2017, but balance would still be achieved in structural terms. To avoid a sharp and unwarranted fiscal consolidation in subsequent years, Lithuania should revisit its fiscal rules, which are unnecessarily stringent relative to EU and euro area requirements.

A medium-term target of 0.5 percent of GDP for the structural fiscal deficit is appropriate for Lithuania. Its achievement would rebuild the fiscal buffers essential for a small open economy. Room under this target is available to finance fiscal structural reforms. One-off costs of structural reforms should be accommodated in addition. In the longer run, public finances are set to come under pressure from rising age-related spending and declining EU funds. Rather than cutting benefits or scaling back investment, Lithuania should boost its low tax revenues, primarily through tax administration improvements, but also through selected tax policy measures.

Fiscal structural reforms should focus on pro-growth and pro-equity measures. The government could consider lowering social contributions for low-wage earners, broadening active labor market programs, and making unemployment benefits more generous. The government's intention to improve the quality of public spending through performance-based budgeting is welcome, although payoffs may materialize only over time.

In the financial sector, there are no immediate risks to stability, but Nordic-Baltic cooperation should be strengthened further. Strong soundness indicators and stress tests attest to the resiliency of the sector. Spillovers from vulnerabilities in parent banks are a potential risk going forward. Nordic-Baltic cooperation should hence be strengthened, including through the planned crisis simulation exercise, in which ECB supervisors should participate. The revival of credit growth is generally welcome and its pace appears to remain prudent, but this should be monitored. The strength of some small non-systemic financial institutions also needs continued attention. Credit union reform is on track and should be completed in line with current plans.

Lithuania’s external balance is broadly consistent with medium-term fundamentals. External stability and exchange rate alignment are not immediate concerns, but the persistent increase of unit labor costs, together with signs of sliding export shares, require close monitoring.

Amongst structural reforms, overhauling the education system should be at the top of the priority list. Addressing poor educational outcomes requires improving the management of educational institutions, stepping up standard setting and enforcement, tackling rapidly rising overcapacities due to declining school-age populations, and ensuring better pay for a smaller teaching staff. Reform needs permeate all levels of education, from higher education, to still underdeveloped vocational training and general education.

Innovation promotion policy is another critical area. Efforts to date have achieved relatively little compared to the allocated public resources. To overcome the high fragmentation of the system, the number of implementing, advisory, and decision making institutions needs to be reduced through mergers. There should be fewer promotion instruments that can be used more flexibly for a broader range of innovation activities. Instead of ever more programs that are underused by businesses, direct financial support for innovation-related outlays by businesses should be stepped up.

The recent adoption of a modern Labor Code has further strengthened Lithuania’s generally favorable business environment. Although not perfect in every respect, the new Labor Code is a big step forward and any potential deficiencies should be addressed at a later stage, once some experience has been gathered with how the new legislation works in practice. Ongoing reform of the governance framework for state-owned enterprises is welcome.

Republic of Lithuania: Selected Economic Indicators, 2014–22

Quota (current, % of total): SDR 441.6 million, 0.09 percent
Main products and exports: minerals (incl. refined fuel), agricultural and wood products, chemicals, plastics, textiles

Key export markets: Russia, Latvia, Estonia, Poland, Germany

Per capita GDP (2016): € 13,500

Literacy rate (2015): 99.8 %

At-risk-of-poverty (after transfers), share of population (2015): 29.3%

	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Projections					
Output									
Real GDP growth (annual percentage change)	3.5	1.8	2.3	3.2	3.2	3.2	3.1	3.1	3.0
Domestic demand growth (year-on-year, in percent)	3.4	6.7	2.7	3.4	3.6	3.7	3.5	3.5	3.4
Private consumption growth (year-on-year, in percent)	4.3	4.1	5.6	4.2	3.8	3.5	3.2	3.2	3.0
Domestic fixed investment growth (year-on-year, in percent)	3.7	4.7	-0.5	2.7	4.8	5.5	5.7	5.7	5.7
Inventories (contribution to growth)	-0.2	2.9	-1.0	0.0	0.0	0.0	0.0	0.0	0.0
Net external demand (contribution to growth)	0.2	-5.2	-0.5	-0.3	-0.5	-0.6	-0.5	-0.5	-0.6
Nominal GDP (in billions of euro)	36.6	37.3	38.6	41.0	43.2	45.5	48.1	50.9	53.7
Output gap (percent of potential GDP)	-0.1	-0.9	-0.8	-0.4	-0.1	0.0	0.0	0.0	0.0
Employment									
Employment rate (year average, in percent of labor force)	2.0	1.2	2.0	1.5	0.7	0.6	0.5	0.2	0.1
Unemployment rate (year average, in percent of labor force)	10.7	9.1	7.9	7.4	7.2	7.0	6.8	6.7	6.7
Average monthly gross earnings (annual percentage change)	4.5	5.1	7.9	7.6	6.0	5.6	5.6	5.6	5.5
Average monthly gross earnings, real (CPI-deflated, annual percentage change)	4.3	5.8	7.2	4.0	3.9	3.4	3.0	3.0	2.9
Labor productivity (annual percentage change)	1.4	0.6	0.3	1.7	2.5	2.6	2.7	2.9	3.0
Prices									
HICP, end of period (year-on-year percentage change)	-0.1	-0.2	2.0	3.0	2.0	2.2	2.5	2.5	2.5
GDP deflator (year-on-year percentage change)	1.0	0.2	1.2	2.7	2.0	2.2	2.4	2.5	2.5
HICP core, period average (annual percentage change)	0.7	1.9	1.7	1.9	2.0	2.2	2.4	2.4	2.4
HICP, period average (annual percentage change)	0.2	-0.7	0.7	3.4	2.0	2.2	2.5	2.5	2.5
General government finances 2/									
Revenue (percent of GDP)	34.0	34.8	34.5	35.3	36.8	36.4	36.4	36.2	36.1
Of which EU grants	2.7	1.9	0.8	1.3	2.3	2.0	2.0	2.0	1.9
Expenditure (percent of GDP)	34.6	35.0	34.2	35.8	36.7	36.4	36.5	36.3	36.2
Of which: Non-interest	33.1	33.5	32.8	34.2	35.0	34.8	34.9	34.8	34.8
Fiscal balance (percent of GDP)	-0.7	-0.2	0.3	-0.4	0.1	0.0	-0.1	-0.1	-0.1
Fiscal balance excl. one-offs (percent of GDP)	-1.1	-0.5	0.2	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1
Structural fiscal balance (percent of potential GDP) 3/	-0.9	-0.2	0.6	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
General government gross debt (percent of GDP)	40.5	42.7	40.2	38.3	36.3	34.4	32.7	30.9	29.4
Of which: Foreign currency-denominated	31.9	11.9	11.3	10.8	10.2	9.7	9.2	8.7	8.3
Credit									
Private sector credit (end of period, percent change)	-0.9	4.1	7.3	6.8	6.6	...	...	...	...
Long-term lending rate to private sector	7.0	8.0	6.6	...	...	...	...	...	...
Short-term lending rate to private sector	2.7	2.5	2.3	...	...	...	...	...	...
Balance of payments (in percent of GDP, unless otherwise specified)									
Current account balance	3.6	-2.3	-0.9	-1.6	-1.5	-1.8	-2.2	-2.4	-2.6
Exports of goods and services (volume change, in percent)	3.5	-0.4	3.5	4.3	3.9	4.1	4.2	4.4	4.4
Imports of goods and services (volume change, in percent)	3.3	6.2	3.9	4.5	4.3	4.6	4.6	4.8	4.8
Foreign direct investment, net	0.0	-1.9	0.2	-1.5	-1.7	-1.8	-1.9	-1.9	-1.9
Short-term debt at original maturity	22.6	26.9	40.2	40.2	38.6	36.4	34.2	31.9	29.8
Gross external debt 4/	69.8	75.9	86.4	84.1	80.5	76.5	72.4	68.5	64.8
Exchange rates									
Real effective exchange rate (2005=100, +=appreciation)	120.7	118.9	121.0	..	..	..	..	..	..
Exchange rate (euro per U.S. dollar, end of period)	0.81	0.92	0.95	..	..	..	..	..	..
Exchange rate (euro per U.S. dollar, period average)	0.75	0.90	0.90	..	..	..	..	..	..
Saving-investment balance (in percent of GDP)									
Gross national saving	22.3	17.6	15.5	15.4	15.5	15.4	15.4	15.8	16.1
Gross national investment	18.7	19.9	16.4	17.0	17.0	17.2	17.6	18.1	18.7
Foreign net savings	-3.6	2.3	0.9	1.6	1.5	1.8	2.2	2.4	2.6

Sources: Lithuanian authorities; World Bank; Eurostat; and IMF staff estimates and projections.
1/ Data are presented on ESA2010, and BPM6 manuals basis.
2/ The numbers for 2014 include 302 million euros (0.8 percent of GDP) in compensation payments for past pension cuts on accrued basis. The payments are spread over 2014-16, affecting the debt profile for these years. ESM contributions are spread over 2015-19 and also increase debt. Passive projections from 2016 onward; incorporate only announced budgetary measures; budgetary impact of further defense spending, wage compensation and their potential offsetting measures are not included.
3/ Calculation takes into account standard cyclical adjustments as well as absorption gap.
4/ Government external debt excludes guaranteed loans.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LITHUANIA

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

June 15, 2017

KEY ISSUES

Context. Lithuania has experienced strong convergence since the mid-1990s, but the catch-up of productivity with Western Europe has stalled in the last three years. While a cyclical upswing is likely to lift growth to 3.2 percent this year and next, structural reforms are essential to support strong medium-term performance. The government that took office in December is committed to a "social market economy," but its reform agenda may be difficult to implement without greater focus on key measures.

Key policy issues:

- **Maintaining macroeconomic and financial stability.** Public finances recorded their first ever surplus last year, exceeding the recommended target for the structural fiscal deficit of 0.5 percent of GDP, which remains appropriate. The financial sector is generally sound, but would benefit from stronger cooperation with parent-bank authorities. Deleveraging has given way to private-sector credit growth, which is a welcome development overall. But the strong wage dynamics of recent years need monitoring, so they do not dent competitiveness and undermine growth potential.
- **Supportive structural reforms.** Raising Lithuania's medium-term growth potential hinges mainly on structural reforms. The modernization of labor relations through adoption of a new labor code is welcome. The top priorities are now education reform, to address poor educational outcomes and to deal with overcapacities, and an overhaul of innovation promotion, which has suffered from excessive emphasis on infrastructure and on the supply of narrow programs that have generated limited interest from businesses.
- **Supportive fiscal structural reforms.** Measures should be geared toward promoting growth and the government's income equality objectives. Cutting social contributions for low-wage earners, broader ALMPs, and more generous unemployment benefits should be considered. Room under the recommended fiscal deficit target is available to finance these initiatives. Longer-term pressures on public finances from age-related spending and declining EU funds should be counteracted by boosting Lithuania's low tax revenues, primarily by strengthening tax administration, but selected tax policy measures should also be considered.

Approved By
P. Gerson and V. Kramarenko

Discussions were held in Vilnius during May 4–15, 2017. The team comprised Mr. Klingen (head), Mr. Ioannou, Mr. Xie (all EUR), and Mr. Grolleman (MCM). Mr. Gracia (EUR), the incoming mission chief, joined the final days of the mission. Mr. Bartkus (OED) participated in most of the meetings. Ms. Nguyen and Ms. Jung supported the mission from headquarters.

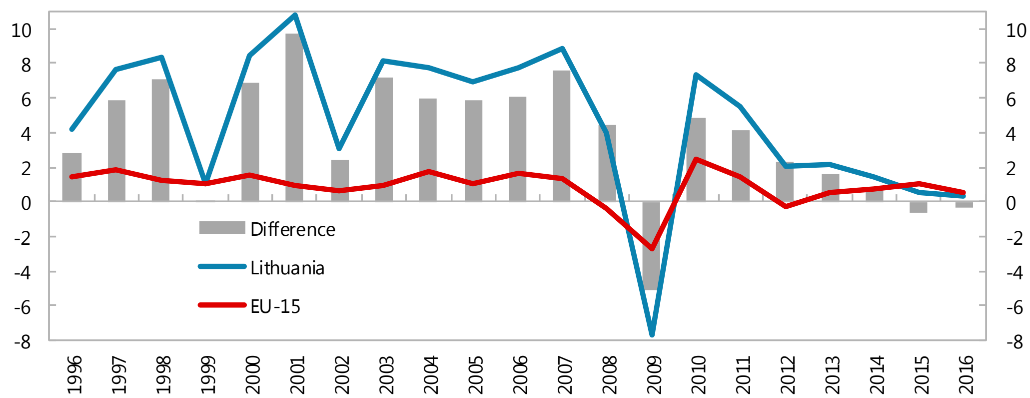
CONTENTS

CONTEXT

1. **Lithuania's long-term economic growth record has been among the best in the region, but income convergence with Western Europe has recently stalled.** Annual average GDP growth and labor productivity gains since the late 1990s are the second highest in Central, Eastern, and Southeastern Europe (CESEE), bringing per capita income to 45 percent of the EU average in nominal terms and 75 percent in purchasing power parity terms. But in the last three years, productivity growth has languished below 1 percent and convergence with Western Europe has come to a halt—in common with much of CESEE. Income inequality and poverty rates remain high in Lithuania, potentially weighing on growth and conflicting with social objectives.

Lithuania: Real Productivity Convergence, 1996–2016

(Percent Change in real GDP per employed person)



Sources: Eurostat; and IMF staff calculations.

2. **Lithuania's main challenge remains reinvigorating income convergence.** For it to be sustainable, Lithuania needs to narrow its productivity gap with Western Europe. Further structural reforms are the main lever to make progress, while macroeconomic and financial stability need to be maintained.

3. **Lithuania's new government has proposed a broad array of reforms.** The new government, led by the Peasant and Greens Union and also comprising the Social Democrats, who headed the previous administration, took office in December 2016. Its program supports a "social market economy," aims to get Lithuania out of a perceived middle-income trap, and seeks to tackle income inequality and regional disparities. While its action plan comprises several hundred reforms, a greater focus on priority areas could maximize its effectiveness.

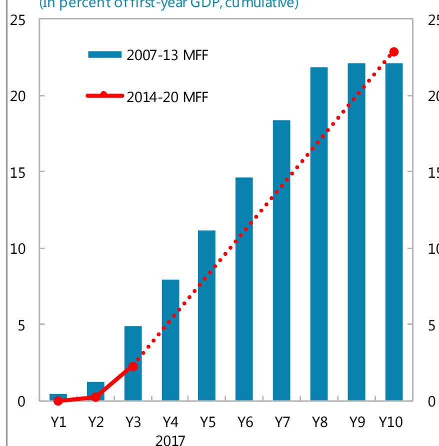
RECENT DEVELOPMENTS

4. **The economy has been gathering momentum since late last year, following sluggish performance in 2015 and most of 2016.** Real GDP expanded by 3.9 percent in the first quarter of this year after rising only by 2.3 and 1.6 percent in 2016 and 2015, respectively. Private consumption has long been a strong driver of growth, on the back of strong wage growth and low inflation that

supported purchasing power. More recently, exports have also been growing, as the external environment improves and the adverse effects from retaliatory Russian trade sanctions and depreciation of the Russian ruble wane. But gross fixed capital formation has remained weak so far, reflecting the still limited absorption of European Structural and Investment Funds (ESIFs) under the Multiannual Financial Framework (MFF) 2014–20. Efforts to embed projects into comprehensive sectoral strategies have delayed spending of ESIFs across CESEE. Staff estimates the output gap to be small and negative, owing to slack in the tradables sector, where the recent revival of external demand has yet to fully unwind years of weakness. In contrast, spare capacity seems exhausted in the labor-intensive non-tradables sector. Rapid wage growth is indicative of a tightening labor market, but also reflects large minimum wage hikes and compensation for meager wage developments in the years flowing the global financial crisis (GFC).

5. Public finances recorded their first ever fiscal surplus in 2016. Revenue-rich growth with strong expansions in wages and retail sales buoyed revenues, improving the fiscal balance from -0.2 percent of GDP in 2015 to 0.3 percent of GDP in 2016, corresponding to a structural fiscal balance of 0.6 percent of GDP based on staff's output gap assessment. Automatic stabilizers dampened economic activity last year and so did the decline of ESIF absorption by over 1 percent of GDP, although fiscal multipliers are estimated to be rather small for Lithuania's small open economy. The public debt ratio fell in 2016 to 40 percent of GDP, thereby helping rebuild fiscal buffers that had suffered in the wake of the GFC when public debt rose from less than 15 percent of GDP in 2008 to 42.7 percent of GDP in 2015.

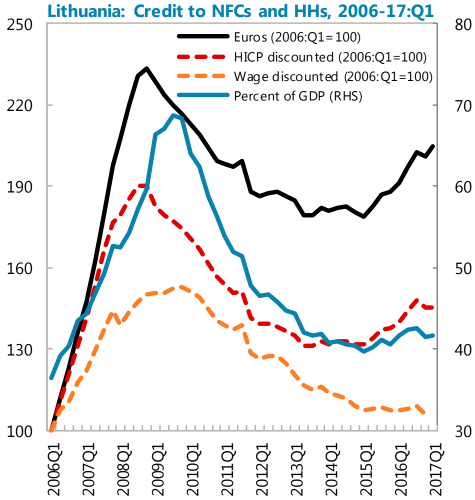
Lithuania: ESIF Absorption under MFFs
(In percent of first-year GDP, cumulative)



Sources: European Commission; and IMF staff calculations.

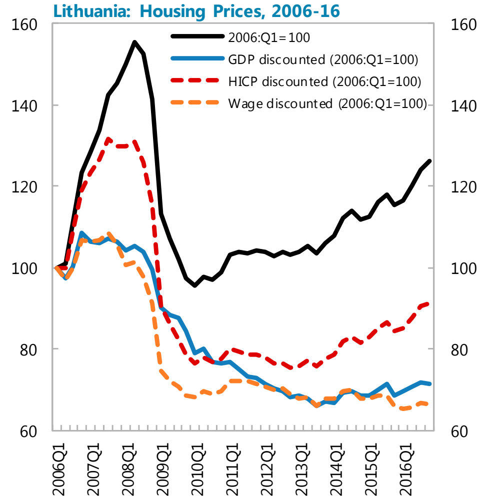
6. Financial conditions are conducive to growth and financial soundness indicators remain strong. After multi-year deleveraging, private-sector credit turned the corner in mid-2015 and reached 7.7 percent for households and 5.4 percent for non-financial companies this April. SMEs are also benefitting. With interest rates for corporate loans and mortgages below 2 percent, financial conditions are accommodative. The stock of private sector credit is still modest at 42 percent of GDP and remains much below its 2008 peak. Housing prices are rising, especially in large cities, and transactions are closing in on their 2007 peak. But as with credit, housing prices are still at historically low levels, especially after adjusting for general inflation. Banks' financial soundness indicators convey resilience with strong capitalization, high liquidity, and healthy profits, despite the low interest rate environment. Spillovers from vulnerabilities in Nordic parent banks, which control much of Lithuania's financial sector, remain a potential risk though. Reform of credit unions is progressing as planned and should strengthen this relatively small sector over time.

Lithuania: Credit to NFCs and HHs, 2006-17:Q1



Sources: Bank of Lithuania; Haver Analytics; and IMF staff calculations.

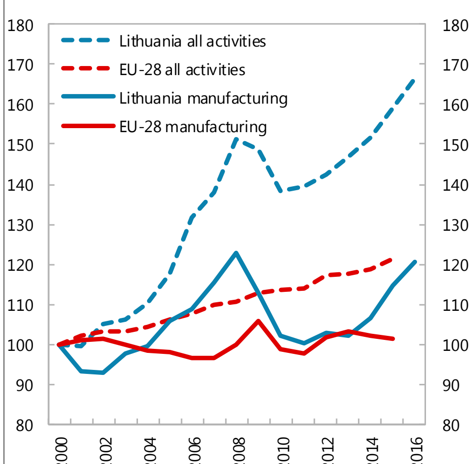
Lithuania: Housing Prices, 2006-16



Sources: Haver Analytics; and IMF staff calculations.

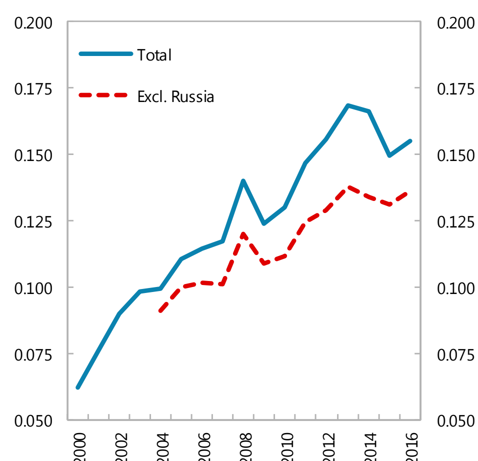
7. Lithuania's external balance is broadly consistent with medium-term fundamentals and desirable policies, but rapid wage growth raises concerns about competitiveness and growth (Box 1). The current account deficit declined from 2.3 to 0.9 percent of GDP in 2016 with the largely energy-related improvement in the terms of trade contributing 1.8 ppts. Weak investment held down imports. External stability and exchange rate alignment are not immediate concerns, but the persistent increase of unit labor costs—some 5 percent for both the whole economy and manufacturing in 2016—together with signs of sliding export market shares require close monitoring. Nominal wage growth remained strong in the first quarter of 2017, reaching 9.3 percent after 7.9 percent in 2016. Resources could shift into the non-tradables sector, where productivity growth has historically been low and is likely to remain so. In the medium term, the external position could suffer and compound the adverse effects from a possible reversal of recent terms-of-trade gains, a revival of investment and associated imports, and a prospective decline in ESIFs in the 2021–27 MFF.

Lithuania and EU-28: Nominal ULCs, 2000-16
(2000=100)



Sources: Eurostat; and IMF staff calculations.

Lithuania: Export Market Shares, 2000-16
(Percent change, goods and services)



Sources: IMF, WEO; Haver; and IMF staff calculations.

Box 1. Republic of Lithuania: External Sector Assessment

In 2016, the current account was assessed to be broadly consistent with medium-term fundamentals and desirable policies. The EBA-lite methodology finds only a small positive current account gap of 0.9 percent of GDP and an associated small real effective exchange rate undervaluation of 1.7 percent. The gap is primarily due to fiscal policy in the rest of the world being looser than desirable in the medium-term. There is hence no immediate need for Lithuania to adjust its policies. But going forward, Lithuania should closely monitor competitiveness to ensure that wage and productivity developments align better than they have in recent years. A reversal of last year's terms-of-trade gain and a revival of investment could also widen the current account balance. It should be noted that the derivation of the EBA-lite current account norm is highly sensitive to demographic projections. The UN projections, which seem to understate population aging, imply a much more negative current account norm than Eurostat projections, which appear to overstate population aging. The current account gap calculations used here are based on the midpoint between both population projections.

The exchange rate appears to be broadly in line with fundamentals. Direct estimation of the REER, through the Equilibrium Real Exchange Rate approach (ERER) indicates that Lithuania's REER is close to equilibrium, with an estimated overvaluation of 2.9 percent. The External Sustainability Approach (ES) shows that the actual current account balance is higher than the level that would stabilize Lithuania's net foreign asset position, and the exchange rate is accordingly undervalued by 1.8 percent. Together with the 1.7 percent undervaluation found in the EBA-lite approach, the results are mixed overall with only small deviations from calculated benchmarks.

Summary Table

CA-Actual	-0.9%	CA-Fitted	0.2%
CA-Norm	-1.8%	Residual	-1.1%
CA-Gap	0.9%	Policy gap	2.0%
Elasticity	-54.0%		
Real Exchange Rate Gap	-1.7%	Cyclical Contributions	0.2%
		Cyclically adjusted CA	-1.1%
		Cyclically adjusted CA Norm	-2.0%

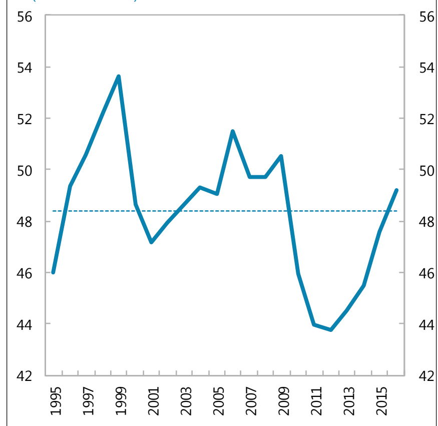
The Net International Investment Position has been on an improving trend since the trough realized at the end of the boom period in 2008/09. It strengthened to -43 percent of GDP in 2016 from -58 percent of GDP before the GFC, with the rollback of parent bank funding chiefly responsible. The loan-to-deposit ratio of the Lithuanian banking system dropped from almost 200 percent to around 100 percent. Foreign direct investment accounts for close to two-thirds of the negative position. Risks of sudden withdrawal and associated external pressures are therefore low.

OUTLOOK AND RISKS

8. **Building on recent momentum, economic growth should be strong this year and next.** Improving external conditions and a turnaround in ESIF absorption, as well as high capacity utilization, should spur exports and investment, respectively. Private consumption will likely remain robust, although some moderation is to be expected as real wages decelerate. Without room from future terms-of-trade gains and the labor share of income already above its long-term average, firms will likely become more resistant to wage pressures. Overall, staff sees real GDP growth pegged at 3.2 percent in the next two years, fast enough to close the output gap in 2018. Productivity growth should recover as the aftereffects of the GFC wane and structural reforms move ahead, lifting potential growth to just over 3 percent in the medium term. Strong domestic demand will pull in imports, leading to a gradual deterioration of the trade balance despite improving export

prospects. In the medium term, the current account deficit is expected to settle at some 2.5 percent of GDP, reflecting the countervailing forces of an aging, but catching-up, economy. Annual average HICP inflation is set to spike to 3.4 percent this year, because of the base effect from the sharp rise in global energy prices in late 2016 and because of excise tax hikes this March, which add some 0.7 ppt. On staff's wage and growth projections, it would fall back in 2018 and reestablish its historical margin of 0.75 ppt over the euro area average typical of a catching-up economy.

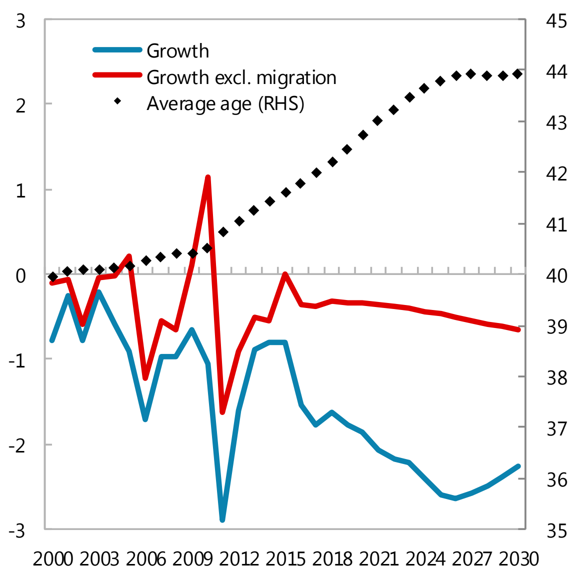
Lithuania: Labor Share of Income, 1995-2015
(Percent of GDP)



Sources: Eurostat; and IMF staff calculations.

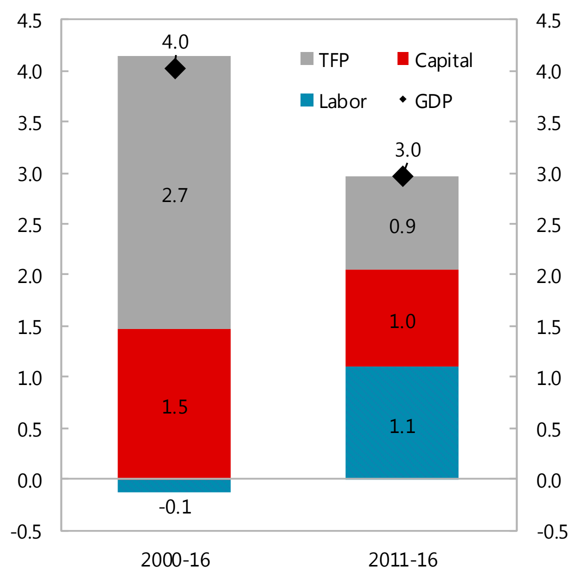
9. Risks are fairly balanced in the short run, but tilted to the downside in the medium term. Lithuania's small open economy is highly exposed to developments in global cross-border integration, in geopolitics, and in global growth. On the domestic front, wage growth could fail to moderate, which may spur growth in the short term, but would cloud the outlook for competitiveness and medium-term growth. More generally, achieving the projected potential growth rate of just above 3 percent could prove challenging, considering Lithuania's adverse demographics and recent weak productivity growth. Productivity will likely benefit from structural reforms, such as the overhaul of the Labor Code, and subsiding aftershocks from the GFC. But additional reforms would help to more securely underpin the medium-term growth projections and mitigate downside risks.

Lithuania: Working Age Population, 2000-30
(Growth in percent and age in years)



Sources: Eurostat; and IMF staff calculations.

Lithuania: Factor Contributions to Real GDP Growth
(Percentage points)



Sources: Haver Analytics; and IMF staff calculations.

Republic of Lithuania: Risk Assessment Matrix[1]

Source of Risks, Likelihood, and Time Horizon	Impact on Lithuania	Recommended Policy Response
High (short to medium term) **Retreat from cross-border integration**. A fraying consensus about the benefits of globalization could lead to protectionism and economic isolationism, leading to reduced global and regional policy collaboration with negative consequences for trade, capital and labor flows, sentiment, and growth.	**Medium** As a small, highly open economy, Lithuania would be affected through trade and confidence channels. But with the single market—Lithuania's largest export destination—the fallout should be contained.	Participate in global and European policy responses. Diversify risk by pushing ahead with export diversification.
High (short to medium term) **Policy and geopolitical uncertainties:** • **Policy uncertainty and divergence.** Two-sided risks to U.S. growth with difficult-to-predict policies and global spillovers. In Europe, uncertainty associated with negotiating post-Brexit arrangements and with upcoming major elections. Policy divergence could lead to rising global imbalances and exacerbate exchange rate and capital flow volatility.	**High/Medium** As a small, highly open economy, Lithuania would be affected through trade, confidence, and FDI channels, but euro area membership, fiscal buffers, and well-capitalized banks are mitigating factors. Growth and employment could suffer.	Participate in coordinated policy responses at the European level. Let fiscal stabilizers operate freely and consider discretionary fiscal policy.
High/Medium (medium term) **Weaker-than-expected global growth:** • **Structurally weak growth in key advanced and emerging economies:** Low productivity growth (U.S., the Euro Area, and Japan), a failure to fully address crisis legacies and undertake structural reforms, and persistently low inflation (the Euro Area, and Japan) undermine medium-term growth in advanced economies (high likelihood). Resource misallocation and policy missteps, including insufficient reforms, exacerbate declining productivity growth in emerging markets (medium likelihood).	**High/Medium** As a small, highly open economy, Lithuania would be affected through trade, confidence, and FDI channels. Growth and employment could suffer.	Participate in coordinated policy responses at the European level. Diversify exports to more dynamic destinations. Redouble efforts to spur domestic productivity growth.
Financial conditions: **High** (short term) • **Significant further strengthening of the U.S. dollar and/or higher rates.** As investors reassess policy fundamentals, as term premia decompress, or if there is a more rapid Fed normalization, leveraged firms, lower-rated sovereigns and those with un-hedged dollar exposures could come under stress. Could also result in capital account pressures for some economies. **Medium** (short term) • **European bank distress:** Strained bank balance sheets amid a weak profitability outlook could lead to financial distress in one or more major banks with possible knock-on effects on the broader financial sector and for sovereign yields in vulnerable economies.	**Low** Lithuania's external competitiveness would strengthen. Higher interest rates could somewhat cool economic momentum, but low leverage in the economy would guard against financial stress. **Medium** Potential vulnerabilities in parent banks could spill over to Lithuania, curtailing credit supply.	Let automatic fiscal multipliers operate freely. Consider discretionary fiscal policy in case of a severe growth setback. Step up collaboration with home country supervisors and crisis preparedness.
Medium (medium term) **Risks to competitiveness:** Wage growth continues to significantly outstrip productivity growth for an extended period.	**Medium** Competitiveness and growth potential would suffer.	Redouble efforts to boost productivity growth and cool wage dynamics.
Medium (medium term) **Risks to income convergence:** Post-GFC productivity fails to pick up and structural reforms to boost productivity fall short.	**High** Catching-up with living standards in Western Europe would stall. Dealing with population aging would be more difficult.	Redouble efforts to implement a focused structural reform program.

[1]The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutu exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

10. The authorities broadly concurred with the mission's outlook, but saw no slack in the economy and were more cautious about medium-term prospects for growth. Staff's growth and inflation projections are similar to those of the Bank of Lithuania and the Ministry of Finance. But both saw the economy currently operating slightly above potential, with rapid wage growth signaling tight labor markets, some pockets of spare capacity in the tradable sector notwithstanding. Moreover, this year and next, actual growth would exceed potential growth, widening the positive output gap. Because of adverse demographics and limits to lifting productivity growth, employment would stop growing this year and then decline, implying continued tight labor markets and potential growth of no more than 2.5 percent. Accordingly, risks to competitiveness and income convergence are very relevant.

POLICY DISCUSSIONS

Lithuania's key priority remains to spur robust and equitable growth. Macroeconomic and financial stability needs to be preserved. Discussions focused on a structural reform agenda in support of income and productivity convergence with Western Europe and the government's income equality objectives. Education and innovation policies, along with fiscal structural reforms, have a prominent role to play.

A. Preserving Macroeconomic and Financial Stability as a Prerequisite for Continued Economic Success

11. Public finances are set to remain strong in 2017. The budget substantially increases the basic income tax allowance, indexes pensions to the growth of the wage base in the economy, and raises investment. With excise tax hikes on alcohol and tobacco and continued revenue-rich growth providing only a partial offset, the general government balance is set to deteriorate to -0.4 percent of GDP, corresponding to a structural balance of -0.1 percent of GDP after accounting for one-offs and staff's output gap estimate.

Lithuania: Main Fiscal Measures in 2017

	Percent of GDP
Revenue measures	-0.13
Personal income tax	-0.36
Other direct taxes	0.01
VAT	0.01
Excises	0.20
Social contributions	0.01
Expenditure measures	1.16
Compensation of employees 1/	0.29
Social benefits 1/	0.60
Capital spending 2/	0.27
Net impact on budget balance	-1.28

Sources: Lithuanian authorities; and IMF staff estimates.

1/ Against a counterfactual of not granting any wage or benefit increases.
2/ Includes defense expenditure.

12. A medium-term target for the structural balance of -0.5 percent of GDP remains advisable and would ensure future fiscal prudence. Maintaining this balance would reduce the public debt ratio to 31 percent of GDP by 2022, compared to 15 percent of GDP prior to the GFC. Lithuania needs large fiscal buffers to deal with external shocks to its small open economy and in preparation for medium-term demographic spending pressures and the prospective decline of ESIFs in the 2021–27 MFF. The debt sustainability analysis suggests that Lithuania's debt will remain manageable under different scenarios and if the country is hit by shocks(Annex). Room under this target is available to strengthen the economy's supply side. One-off costs for structural reforms should be accommodated in addition.

13. Pressures on public finances that will build in the longer run are best addressed by boosting tax revenues. Lithuania's tax-to-GDP ratio is one of the lowest in Europe. About half of the difference relative to the EU average is estimated by staff to reflect tax administration shortcomings and the shadow economy, while about 40 percent can be traced to low tax rates or the absence of certain taxes, and 10 percent arises from differences in the economic structure.[1] There are indications that efforts to improve tax administration through the introduction of a VAT register are beginning to pay off, but much remains to be done. Organizationally, too many staff are still located in regional offices and too few are assigned to audit and verification tasks. Programs targeting high-wealth individuals and the construction sector have yet to seriously take off. In the longer run, consideration should be given to unifying tax and social contribution collection and giving the merged entity more autonomy. In terms of tax policy, personal and corporate income tax rates are low and riddled with special schemes. Wealth and capital income are lightly taxed, especially capital gains in real estate transactions.[2]

Contributions to Lithuania's Tax Underperformance Relative to the EU, 2015

(Percent of GDP)

	Tax Revenues	Tax policy	Economic Structure	Tax administration
Total tax revenues shortfall	10.7	3.8	1.2	5.7
PIT	5.5	2.5	0.8	2.3
CIT	1.0	1.0	-0.2	0.2
VAT	-0.7	-2.5	-0.4	2.1
Excise taxes	-0.8	0.5	-1.4	0.1
Taxes on land, buildings and other structures	0.9	0.2	0.7	0.0
Social security contributions	1.3	-1.2	1.7	0.7
Other taxes	3.5	3.2	0.0	0.3
Car registration tax	0.1	0.2	-0.1	0.0
Other taxes not in existence in Lithuania 1/	2.8	2.8	0.0	0.0
Other 2/	0.6	0.2	0.1	0.3

Sources: Eurostat and other sources; and IMF staff estimates.

1/ Including taxes on financial and capital transactions; taxes on insurance premiums; wage bill and payroll taxes; taxes on pollution; and taxes on capital.

2/ Contributions based on the total contribution of taxes analyzed.

14. Implementing a fiscal strategy conducive to boosting productivity growth may require revisiting Lithuania's fiscal rules, which are more stringent than those required by the EU or the euro area. Specifically, Lithuania's fiscal rules guide the structural balance into surplus through an adjustment mechanism that either restricts nominal expenditure growth to half of nominal potential growth or requires a 1 percent of GDP improvement in the headline balance each year until the five-year average of the fiscal balance reaches 0.1 percent of GDP. There are some escape clauses that suspend the adjustment mechanism, e.g. the output gap is negative or the Lithuanian economy grows slowly relative to the euro area. These rules impose more fiscal discipline than required under the SGP and the Fiscal Compact or the medium-term objective of a 1 percent of GDP fiscal deficit adopted by Parliament and notified to the European Commission. It is not yet clear whether escape clauses will apply when the 2018 budget is prepared, but in all likelihood, the

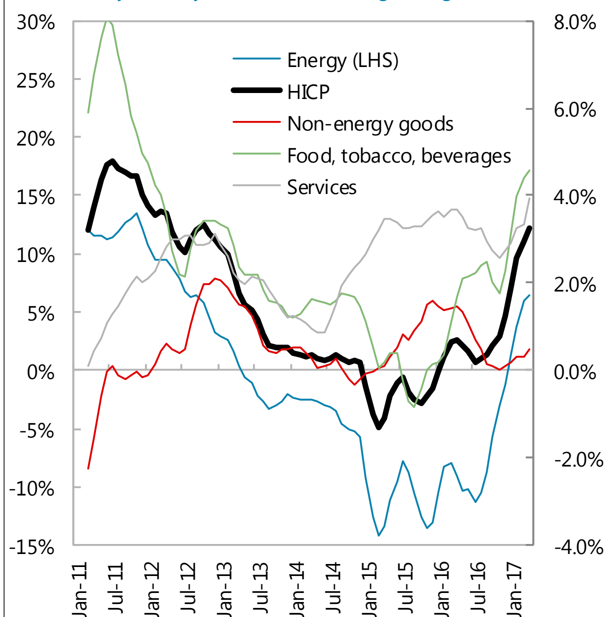
[1] See Selected Issues Paper "What Explains Lithuania's Low Tax-to-GDP Ratio," by I. Ioannou.

[2] The impact of possible tax administration and tax policy reforms is not included in medium-term fiscal projections.

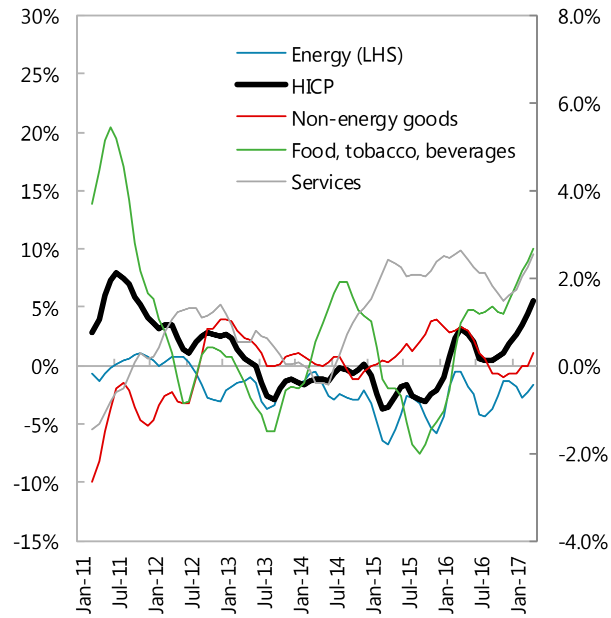
adjustment mechanism will kick in for 2019 and 2020, imposing a sharply negative fiscal impulse that is inadvisable under both cyclical and medium-term structural considerations.

15. Wage developments need to be closely monitored. Competitiveness could suffer and inflation pushed up should real wage growth fail to better align with productivity developments in the future. While the government has limited tools to influence private sector developments in the short run, its decision to forgo minimum wage hikes this year after a string of large increases during 2012–16, as well as the loosening of restrictions on immigration from non-EU countries for selected professions, are welcome steps to cool the labor market. These efforts may need to be supplemented by effectively communicating competitiveness concerns and by stepping up structural measures to boost labor supply.

Inflation and Components, 2011-17
(Percent, year-on-year, 3-month moving average)



Inflation Differential with Euro Aera and Components, 2011-17
(Percent, year-on-year, 3-month moving average)



Sources: ECB; and IMF staff estimates.

16. There are no immediate risks to financial stability, but close collaboration with the authorities of parent banks remains essential and domestic housing price developments should be watched. The now completed centralization of supervisory functions in the Bank of Lithuania has created an effective system. Going forward, consideration could be given to further strengthening the accountability and decision-making framework of the Supervision Service. In addition, the governance of consumer dispute resolution could be enhanced by more independent oversight. To get a better sense of potential spillovers from vulnerabilities in parent banks and to be prepared, cooperation in the Nordic-Baltic Stability Group (NBSG) should be further enhanced. Important steps in this direction are the recently concluded MoU on liquidity provision and the planned crisis simulation exercise. ECB supervisors should participate, as they are directly in charge of some three quarters of the Lithuanian banking sector. In addition, the group should collect data for network stress testing, establish guidelines for common solvency and viability assessments, and develop agency-specific crisis management plans. Housing price developments in Lithuania are not an immediate concern, but the Bank of Lithuania rightly keeps an eye on possible overheating and froth in certain market segments. Macroprudential tools are in place to step in if needed. The strength of some small non-systemic financial institutions needs continued attention and credit union reform should be completed in line with current plans.

17. The authorities underscored their strong commitment to macroeconomic and financial stability. Regarding fiscal policy, the Ministry of Finance sees a case for fiscal consolidation in 2018, because in its assessment the output gap is positive and widening and because the deficits of the past should be compensated by surpluses in good times. But they also acknowledged that the sharp consolidation that the fiscal rules may require could be difficult to achieve, especially when trying to implement pro-growth and pro-equity measures at the same time, unless the government's plans to streamline the civil service, to save through introducing performance-based budgeting, and to improve tax administration yield quick results. Regarding financial stability, ECB supervisors pointed to the strong soundness of the three significant institutions' main indicators for solvency, liquidity, and credit quality. Their profitability exceeds the average of banks that they supervise in the euro area, primarily because of lower operating expenses and impairment costs. However, the authorities underlined that the high level of profitability is also explained by the one-off effect of the purchase of VISA Europe shares by VISA Inc. across Europe. The pickup of credit growth is not an immediate concern, but is being monitored at the individual bank level. The Bank of Lithuania was reassured about the banking system's resiliency by its stress tests, which included large drops in housing prices. Its latest stability assessment identifies medium-rated risks related to fast credit and housing price growth and spillovers from potential vulnerabilities in Nordic parent banks. Regarding the latter, the authorities explained that formal stress tests have not been carried out, but financial subsidiary-parent exposures are much reduced, while linkages from centralized liquidity management and common infrastructure are harder to assess. The Nordic-Baltic authorities are further developing the regional cooperation platforms, including possibilities for ECB involvement. ECB supervisors did not rule out agreeing to participate, should an invitation be extended to them.

B. Pushing Key Structural Reforms as Levers for Sustainable Convergence

18. Lithuania's business environment is generally favorable and has been further strengthened by the adoption of a modern labor code. Ease of doing business and competitiveness rankings place Lithuania third in CESEE. A new labor code was adopted in early June after a six-month implementation postponement to July by the new government to take on board amendments agreed in the Tripartite Council. The new legislation shortens notice and severance pay periods, introduces an updated set of contracts, requires the establishment of work councils, improves wage transparency, and introduces a right to time off for training. While not perfect, the new legislation is a big step forward and any deficiencies should be addressed after acquiring experience with how the new code works in practice. Issues to monitor include whether safeguards to limit the use of fix-term contracts are sufficient; whether restriction on overtime should be further eased; and whether more generous unemployment benefits could substitute for the planned central fund that provides supplementary severance pay for long-serving employees. Ongoing further reform of state-owned enterprises in the context of OECD accession is welcome and should enhance their efficiency, as well as that of the wider economy to which it provides key inputs. Plans include merging smaller SOEs with similar functions and ensuring greater presence of independent board and management members in all SOEs, no matter what their legal form.

19. Amongst structural reforms, addressing Lithuania's relatively poor educational outcomes is a top priority, considering the close link between human capital and economic productivity. The tertiary attainment rate of 58.3 percent exceeds the EU average of 39 percent, but educational outcomes compare unfavorably. In the OECD's PISA survey, students scored considerably below their peers. Adult skills lag primarily regarding the "ability to work in a technology-rich environment" according to the OECD's PIAAC survey. The share of high achievers in numeracy and literacy is also considerably lower than elsewhere. Vocational training remains underdeveloped, accounting for only 26.8 percent of upper-secondary-education enrollment compared to 48 percent in the EU. In tertiary education, students often enroll in fields that do not align well with labor market needs and it is not uncommon for university graduates to subsequently sign up for vocational training. Thus, some 40 percent of firms reported an inadequately qualified workforce as a major constraint, compared to around 16 percent on average in both the OECD and the EU.

Lithuania and Selected Regions: Skills of Students and Adults, 2015

	PISA			PIAAC				
	Mathematics	Science	Reading	Numeracy		Literacy		IT 1/
	score	score	score	score	high perf. 2/	score	high perf. 2/	high perf. 3/
Lithuania	478	475	472	267	41.8	267	40.8	17.6
OECD average	490	493	493	263	43.1	268	46.0	31.1
EU average	489	490	488	268	46.0	270	47.1	30.7
WE4 4/	495	498	498	259	39.1	264	41.9	35.5
Other Baltics 5/	501	512	503	273	49.1	276	52.3	27.6
CEE4 6/	487	483	479	264	43.3	266	43.9	25.9

Sources: OECD; and IMF staff calculations.
1/ Ability to work in a technology rich environment.
2/ Share of performers in the top three levels out of six levels.
3/ Share of performers in the top two levels out of four levels.
4/ Average of France, Germany, Italy, and UK for PISA. Average of Germany and England for PIAAC/IT.
5/ Average of Estonia and Latvia for PISA. Estonia only for PIAAC.
6/ Average of the Czech Rep., Poland, Hungary, and Slovakia for PISA. Average of Czech Rep., Poland, and Slovakia for PIAAC.

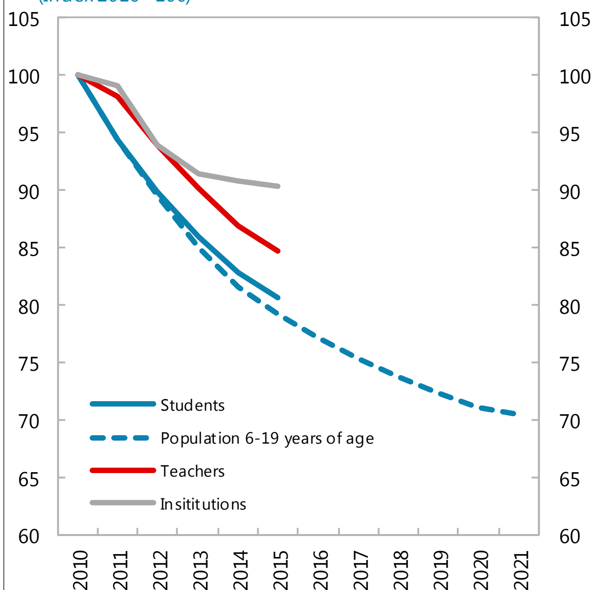
20. Education reform requires a multi-pronged approach, including addressing overcapacities. The sharp demographic decline in the student population has and will further accentuate educational overcapacities. In general education, there are some 30 percent too many teachers; none of the 42 regional vocational training centers runs near capacity; and in tertiary education, there are 22 universities, 23 colleges, and 22 research institutes for a population of less than 3 million. The Ministry of Education and Science should empower educational management, hold it to account, and better exploit its standard-setting powers. Under the current system where funding of educational institutions is tied to enrollment, incentives to lower standards and offer ever more study programs are strong. Efficiency gains from the downsizing of educational capacity should go toward better pay for educators and teacher training, both of which compare unfavorably to EU norms.

Lithuania and Selected Regions: Education Indicators

	Edu. Spending per Student 1/			Student Teacher Ratio			Compensation in Education 2/
	Primary edu.	Secondary edu.	Tertiary edu. 3/	Primary edu.	Secondary edu.	Tertiary edu.	
Lithuania	19.2	18.3	24.4	10.2	7.6	16.1	75.3
OECD average	22.1	25.2	27.1	15.1	13.3	17.2	…
EU average	22.6	26.1	27.1	13.9	12.0	17.5	109.1
WE4 4/	21.8	27.7	30.9	16.7	13.5	16.4	109.3
Other Baltics 5/	26.5	25.2	28.5	11.9	10.5	17.0	75.5
CEE4 6/	22.1	22.9	28.5	14.6	11.8	16.6	102.8

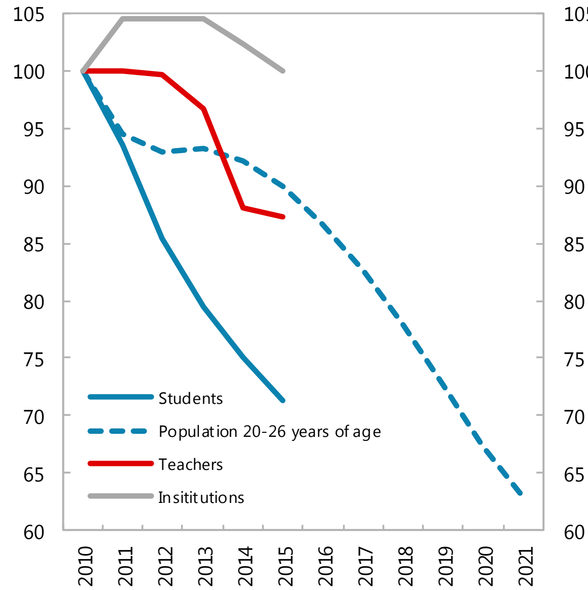
Sources: OECD; Eurostat; and IMF staff calculations.
1/ Percent of p.c. GDP.
2/ Compensation per employee in education as percent of economy-wide compensation per employee.
3/ Excluding R&D.
4/ Average of France, Germany, Italy, and UK.
5/ Average of Estonia and Latvia.
6/ Average of the Czech Rep., Poland, Hungary, and Slovakia.

Lithuania: General Schools, 2010-21
(Index 2010=100)



Sources: Statistics Lithuania; and IMF staff calculations.

Lithuania: Universities and Colleges, 2010-21
(Index 2010=100)

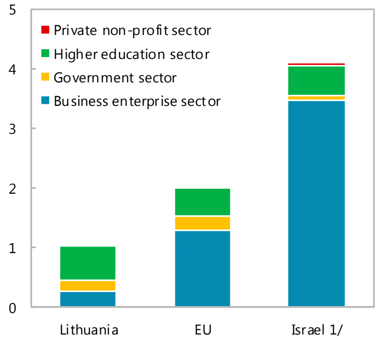


Sources: Statistics Lithuania; and IMF staff calculations.

21. **Making innovation promotion more effective is another priority, considering that it takes an increasingly sophisticated economy with more high-value-added products to underpin continued income convergence.** Lithuania's innovation outcomes lag those of the EU and top performers, such as Israel, by a large margin.[3] R&D outlays by businesses remain low, patent applications are modest, and non-scientific innovation performance, as measured by the introduction of new products, processes, or organizational structures, also disappoints. This is despite a substantial infrastructure buildup and large amounts of ESIFs allocated to RDI promotion. ESIFs totaling some €770 million, or 1.9 percent of 2017 GDP, are earmarked for this purpose for the period 2014–20.

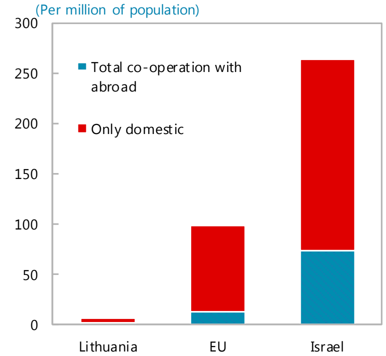
[3] See Selected Issues Paper "Lithuania's Innovation System and Proposals for Reform—Learning from the Experience of Israel," by I. Ioannou and P. Xie.

R&D Expenditure by Components, 2015
(Percent of GDP)



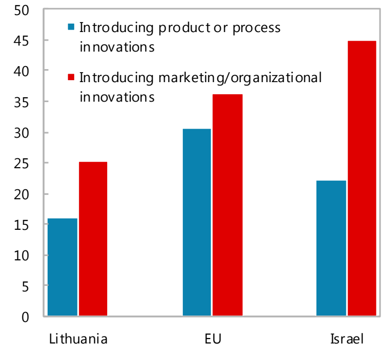
Sources: Eurostat; OECD; World Bank; and IMF staff calculations.
1/ Latest data available for Israel is for 2014.

Patent Applications to PCT, 2013
(Per million of population)



Sources: OECD; World Bank; and IMF staff calculations.

Non-scientific Innovation, 2015
(Percent of total SMEs)



Source: European Commission, Innovation Union Scoreboard.

22. Lithuania's innovation promotion should put businesses in the driver's seat and consolidate the highly fragmented system of institutions and instruments. There are many institutions with advisory and implementation functions under the Ministry of Economy, the Ministry of Education and Science, the Ministry of Finance, government, and parliament. Each has a narrow mandate and there is no effective coordination among them, making it difficult to navigate the system and driving up administrative costs. Drawing on the successful Israeli model, institutions should be merged into a single entity in charge of innovation, akin to the Israel Innovation Authority, and one in charge of basic research and education, akin to the Planning and Budget Committee of the Council for Higher Education in Israel. Lithuania's promotion instruments should also be streamlined into broader and more flexible instruments rather than having a dedicated small-scale support scheme for different steps in the innovation process. Most importantly, funds should be made available directly to businesses to a much larger extent, instead of creating ever more programs where primarily the public-sector supplies services and infrastructure for which there is limited private-sector demand. Take-up of tax incentives has been modest in Lithuania, with few firms availing themselves of the possibility to deduct 300 percent of R&D outlays as expense for income tax purposes. More generally, income tax incentives are likely of secondary importance as young and innovative firms rarely generate large profits in their early years.

23. The authorities agreed with the importance of such reforms, pointing to steps already taken, but seemed intent on also making similar progress in number of other areas. As to education reform, the government has already put forward a plan to merge universities as a first step. On innovation promotion, the authorities agreed that the current system is overly fragmented and would benefit from upgrading the institutional framework, consolidating RDI-related strategic documents, and evaluating and streamlining innovation support measures. These challenges are recognized in the Implementation Plan of the Program of the Government of the Republic of Lithuania and are being addressed. The government has already proposed additional tax incentives for RDI activities, which would create the most generous such scheme in Europe. Investment into technological improvements will be made fully deductible under the corporate income tax and an innovation box will be introduced, which taxes innovation-related income at a lower rate. The authorities underscored the importance of structural reforms, but seemed intent on pushing ahead in other areas just as much, including taxes more broadly, SOEs, and streamlining the public sector for better service delivery. In early June and after the mission, the authorities opened a public consultation process on tax reforms.

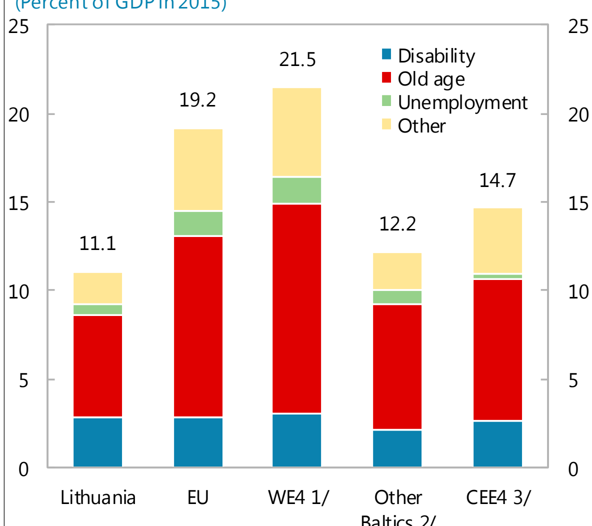
C. Fiscal Structural Reform as a Tool for Pro-Growth, Pro-Equity Measures

24. Fiscal structural reform should focus on pro-growth measures and steps that help realize the government's income equality objectives. Such reforms should be part of a gradual process in order not to unduly distract from the priority reforms in education and innovation promotion. Room under the recommended structural fiscal deficit target of 0.5 percent of GDP is available to finance such measures, but larger initiatives would also need to be accompanied by offsetting measures.

25. The government should consider cutting social security contributions for low-wage earners. Currently, social contributions of almost 40 percent apply from the first euro earned, dwarfing the burden of the personal income tax, which is assessed at a flat rate of only 15 percent and is subject to a basic allowance. A basic allowance could also be considered for social contributions, thereby improving wage equality and strengthening work incentives at the same time. To limit the budgetary costs, the basic allowance could be phased out for higher incomes.

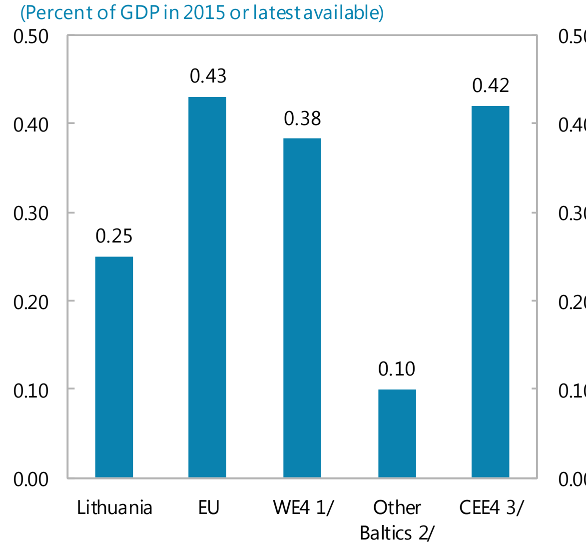
26. Making unemployment benefits more generous and broadening ALMPs would also be advisable. In its current form, unemployment benefits may be insufficient to allow for proper job search according to the OECD's Economic Survey for Lithuania and being unemployed contributes more to income inequality than elsewhere in Europe (Figure 5). ALMP spending is also low by international standards and more than one third of interventions are public works, which do little to increase employability. There should be more emphasis on training, including for those currently employed who need to keep their skills updated to reduce the risk of future job loss. Spare capacities at vocational training centers could usefully be deployed to this end.

Lithuania and Selected Regions: Social Protection Spending
(Percent of GDP in 2015)



1/ Average of France, Germany, Italy, and the UK.
2/ Average of Estonia and Latvia.
3/ Average of the Czech Rep., Hungary, Poland, and Slovakia.
Sources: Eurostat; and IMF staff estimates.

Lithuania and Selected Regions: ALMP Spending
(Percent of GDP in 2015 or latest available)



1/ Average of France, Germany, Italy, and the UK.
2/ Average of Estonia and Latvia.
3/ Average of the Czech Rep., Hungary, Poland, and Slovakia.
Sources: Eurostat; and IMF staff estimates.

27. Old-age pensions likewise play a large role in Lithuania's high degree of income inequality, but reforms can quickly become unaffordable. Replacement ratios are currently only around one third, but pension spending already accounts for some 7 percent of GDP and is projected to rise to 9.4 percent of GDP by 2035. A new pension formula and indexation mechanism is to apply from 2018. While it will imply robust increases in the short run due to indexing benefits to the wage base in the economy, which has expanded strongly in recent years, the demographic future decline of employment together with other changes in the pension formula could reduce the replacement ratio further to as little as 20 percent. The pension formula should be revisited to at least preserve replacement ratios. In addition, it will be important to consider increasing the retirement age further once 65 years for men and women are phased in, scaling back the incidence of disability pensions, and allowing more immigration from non-EU countries.

28. The authorities underscored their intention to use fiscal policy to reduce income inequality. On the tax side, they went ahead with the increase of the basic personal-income-tax allowance legislated under the previous administration. In early June and after the mission, the authorities put forward tax reform ideas, aimed at lowering the burden on low-income earners and families, streamlining special tax regimes, and incentivizing startups. Spurring regional development would also help address income inequality, as rural areas are currently considerably worse off than urban centers. The main tool to achieve this is better provision of infrastructure and social service. Regarding social spending, an extension of unemployment benefit duration from 6 to 9 months and a moderate increase of social assistance benefits is under consideration. Enhancing ALMPs is currently not envisaged, but a new Law on Employment has been under preparation since last year. It seeks to devolve some responsibility for an integrated employment and skill upgrading program to municipalities, which would be supported by the Lithuanian Labor Exchange.

STAFF APPRAISAL

29. The emerging cyclical upswing of the economy is welcome, but Lithuania's productivity gap with Western Europe stopped narrowing in the last three years, raising questions about the sustainability of income convergence. To alleviate downside risks to the medium-term growth outlook, it will not only be important to maintain the sound macroeconomic and financial management of the past. Identifying priority structural reforms that promote growth and help realize the government's income equality objective and then pushing ahead with their implementation is now key.

30. Public finances are vastly improved. A commendable multi-year consolidation effort culminated in the first ever fiscal surplus last year. The public debt ratio declined from its peak in 2015 to some 40 percent. A package of social measures will push the fiscal balance into a deficit in 2017, but balance would still be achieved in structural terms. To avoid a sharp and unwarranted fiscal consolidation in subsequent years, Lithuania should revisit its fiscal rules, which are unnecessarily stringent relative to EU and euro area requirements.

31. A medium-term target of 0.5 percent of GDP for the structural fiscal deficit is appropriate for Lithuania. Its achievement would rebuild the fiscal buffers essential for a small open economy. Room under this target is available to finance fiscal structural reforms. One-off costs of structural reforms should be accommodated in addition. In the longer run, public finances are set to come under pressure from rising age-related spending and declining EU funds. Rather than cutting benefits or scaling back investment, Lithuania should boost its low tax revenues, primarily through tax administration improvements, but also through selected tax policy measures.

32. Fiscal structural reforms should focus on pro-growth and pro-equity measures. The government could consider lowering social contributions for low-wage earners, broadening active labor market programs, and making unemployment benefits more generous. The government's intention to improve the quality of public spending through performance-based budgeting is welcome, although payoffs may materialize only over time.

33. In the financial sector, there are no immediate risks to stability, but Nordic-Baltic cooperation should be strengthened further. Strong soundness indicators and stress tests attest to the resiliency of the sector. Spillovers from vulnerabilities in parent banks are a potential risk going forward. Nordic-Baltic cooperation should hence be strengthened, including through the planned crisis simulation exercise, in which ECB supervisors should participate. The revival of credit growth is generally welcome and its pace appears to remain prudent, but this should be monitored. The strength of some small non-systemic financial institutions also needs continued attention. Credit union reform is on track and should be completed in line with current plans.

34. Lithuania's external balance is broadly consistent with medium-term fundamentals. External stability and exchange rate alignment are not immediate concerns, but the persistent increase of unit labor costs, together with signs of sliding export shares, require close monitoring.

35. Amongst structural reforms, overhauling the education system should be at the top of the priority list. Addressing poor educational outcomes requires improving the management of educational institutions, stepping up standard setting and enforcement, tackling rapidly rising overcapacities due to declining school-age populations, and ensuring better pay for a smaller teaching staff. Reform needs permeate all levels of education, from higher education, to still underdeveloped vocational training and general education.

36. Innovation promotion policy is another critical area. Efforts to date have achieved relatively little compared to the allocated public resources. To overcome the high fragmentation of the system, the number of implementing, advisory, and decision making institutions needs to be reduced through mergers. There should be fewer promotion instruments that can be used more flexibly for a broader range of innovation activities. Instead of ever more programs that are underused by businesses, direct financial support for innovation-related outlays by businesses should be stepped up.

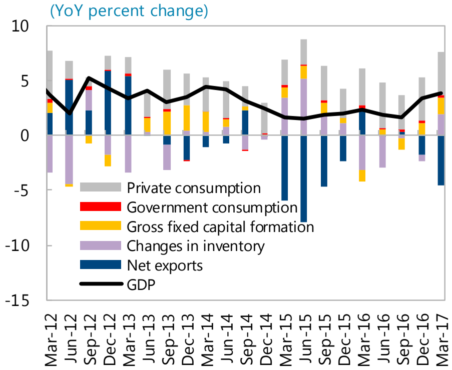
37. The recent adoption of a modern Labor Code has further strengthened Lithuania's generally favorable business environment. Although not perfect in every respect, the new Labor Code is a big step forward and any potential deficiencies should be addressed at a later stage, once some experience has been gathered with how the new legislation works in practice. Ongoing reform of the governance framework for state-owned enterprises is welcome.

38. It is recommended that the next Article IV Consultation be held on the 12-month cycle.

Figure 1. Republic of Lithuania: Real Sector Developments, 2012–17

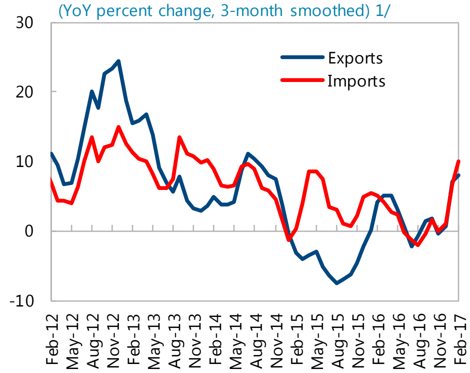
Growth is picking up from recent muted levels …

Real GDP and Its Components
(YoY percent change)



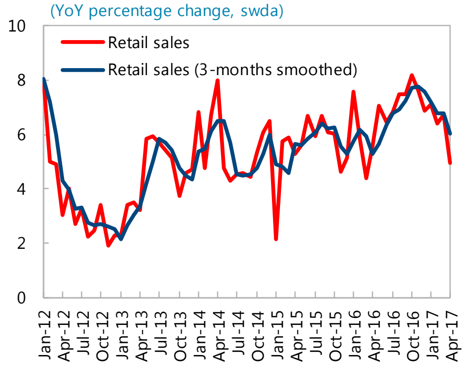
… and trade is reviving.

Real Trade in Goods excl. Mineral Products
(YoY percent change, 3-month smoothed) 1/



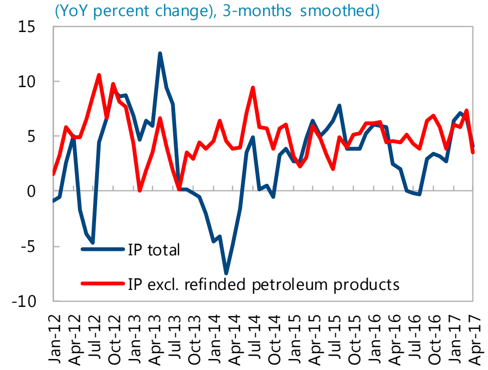
Consumption remains strong …

Retail Sales Volume excl. Cars and Motorcycles
(YoY percentage change, swda)



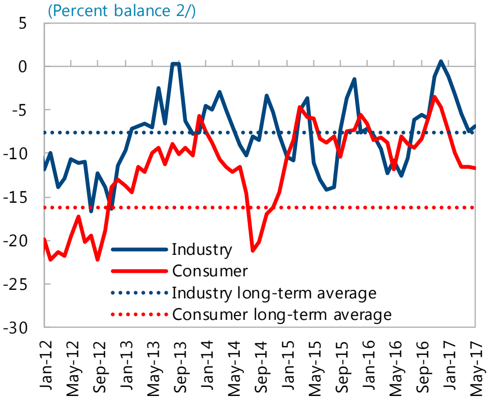
… and industrial production is firming.

Industrial Production
(YoY percent change), 3-months smoothed)



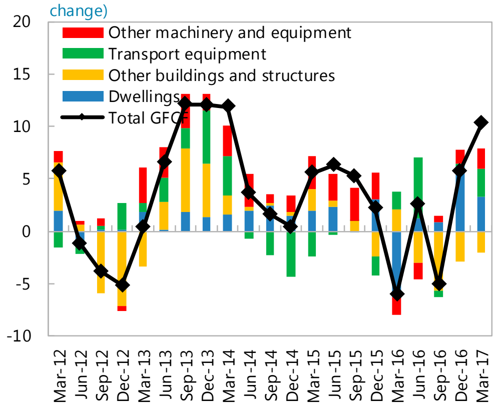
Confidence indicators confirm the positive outlook, …

Business and Consumer Confidence
(Percent balance 2/)



… but investment has yet to make a comeback.

Real Growth in Gross Fixed Capital Formation (Percent change)

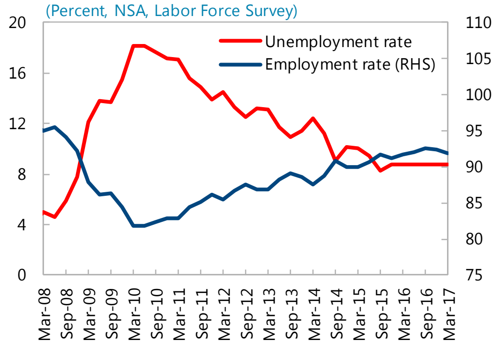


Sources: Haver; Lithuania Statistical Office; and Bank of Lithuania.
1/ The export and import data are measured in terms of F.O.B. and C.I.F., respectively.
2/ Percent balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease.

Figure 2. Republic of Lithuania: Labor Market and Competitiveness Developments

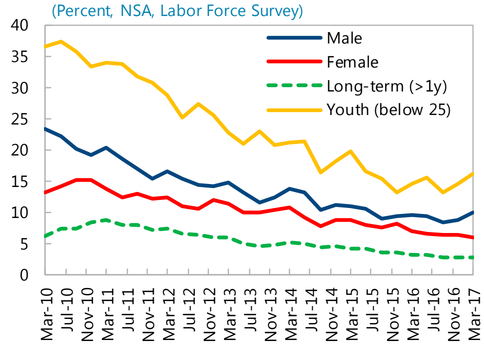
The labor market is tightening …

Employment and Unemployment Rate
(Percent, NSA, Labor Force Survey)



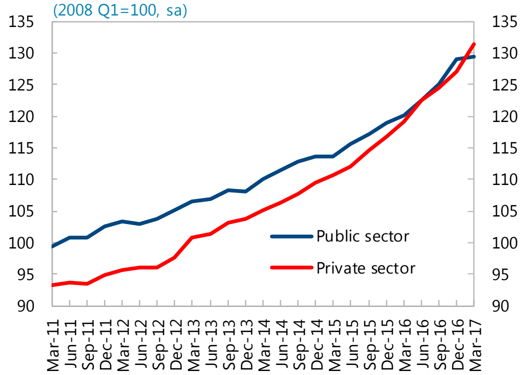
… with unemployment declining across the board.

Unemployment Rate by Sex and Duration
(Percent, NSA, Labor Force Survey)



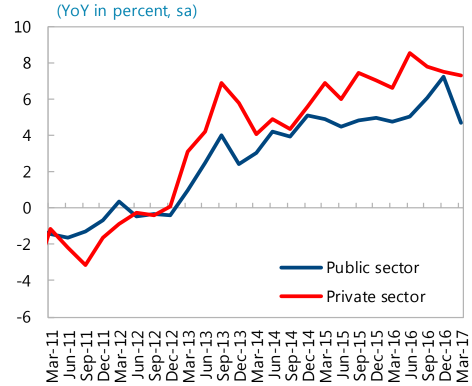
Nominal wages are rising rapidly …

Average Monthly Gross Earnings
(2008 Q1=100, sa)



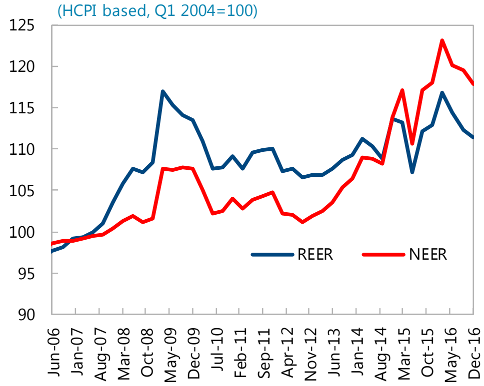
… with the public sector catching up.

Average Monthly Gross Real Earnings Growth Rate
(YoY in percent, sa)



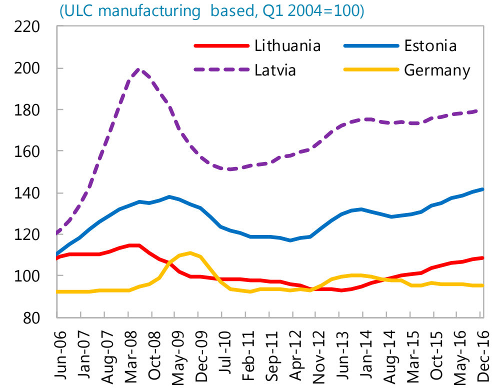
Strong wage growth appreciates effective exchange rates …

Real and Nominal Effective Exchange Rates 1/
(HCPI based, Q1 2004=100)



… while they remain flat in Germany.

REER in Selected Countries 2/
(ULC manufacturing based, Q1 2004=100)

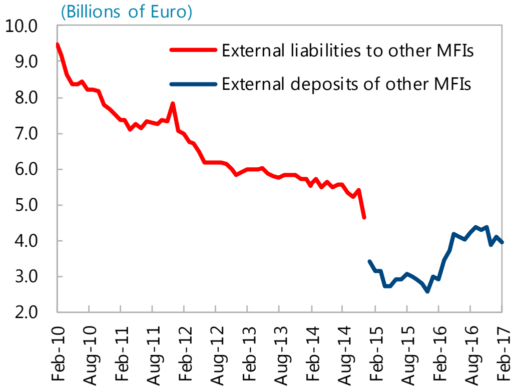


Sources: Haver; Eurostat; Lithuania Statistical Office; and IMF staff calculations.
1/ REER and NEER against a group of 42 trading partners including Russia.
2/ Manufacturing ULC-based REER against a group of 38 trading partners not including Russia.

Figure 3. Republic of Lithuania: Financial Sector Developments

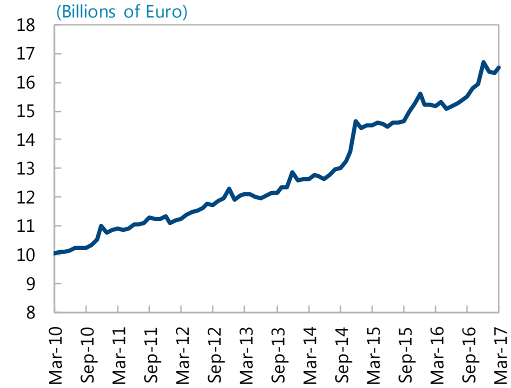
External funding has stabilized at reduced levels …

Banks' External Liabilities
(Billions of Euro)



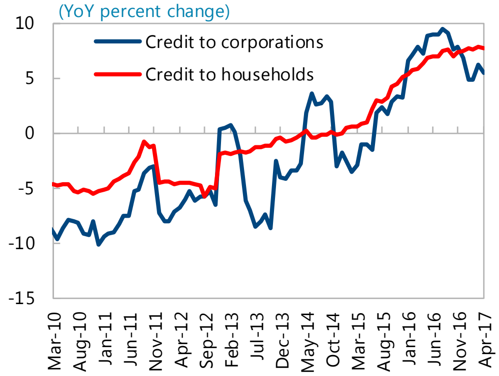
… with strong deposit growth financing bank lending.

Total Deposits of Corporations and Households
(Billions of Euro)



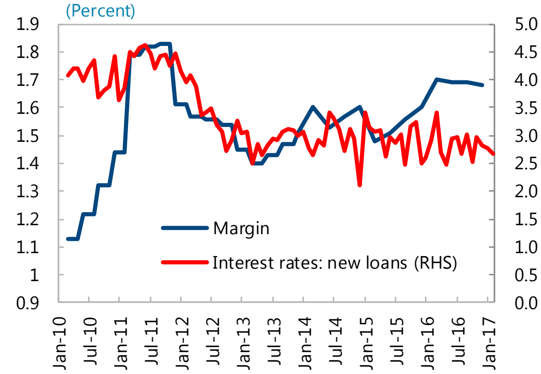
Private sector credit growth is firmly back.

Credit Stock
(YoY percent change)



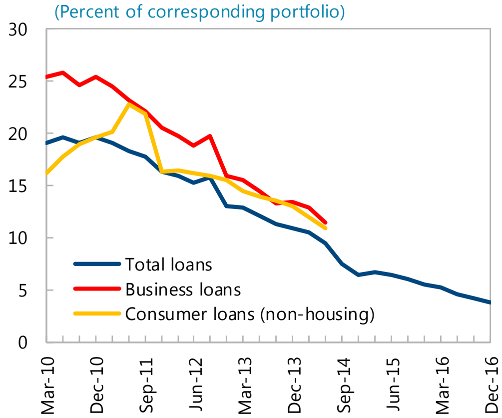
Interest margins are holding up …

Interest Margins
(Percent)



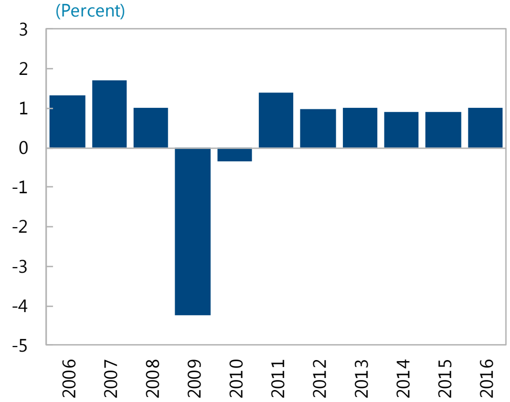
…and with declining NPLs…

Non-performing Loans
(Percent of corresponding portfolio)



… profitability is favorable.

Return on Assets
(Percent)

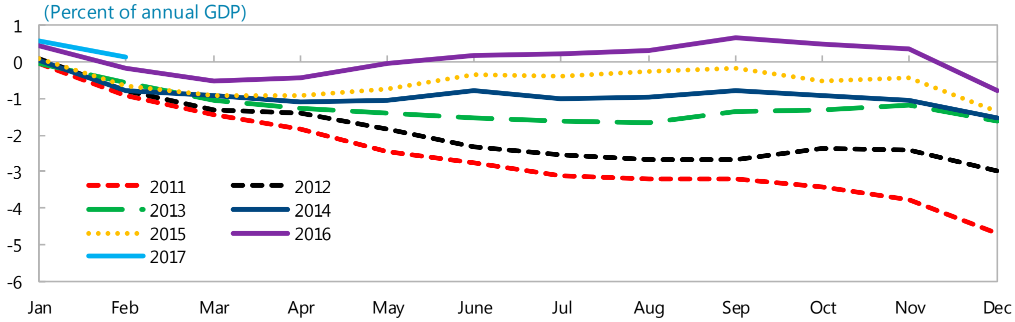


Sources: Dx Time; Bank of Lithuania; and IMF staff calculations.

Figure 4. Republic of Lithuania: Fiscal Developments

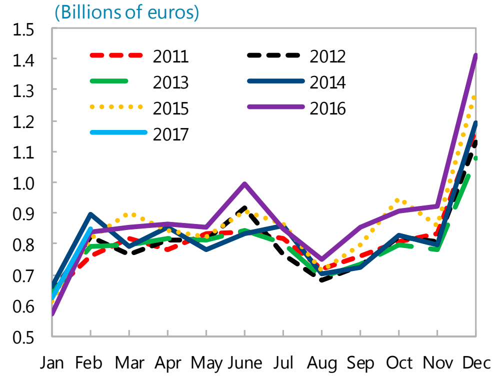
The central government cash deficit continued to improve again in 2016…

Cumulative Central Government Cash Balance 1/
(Percent of annual GDP)



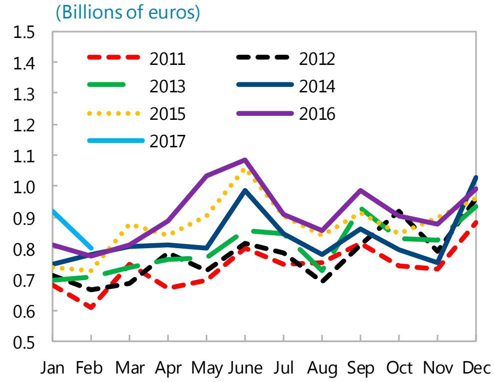
… with non-investment spending similar to last year,…

Total Primary Expenditures
(Billions of euros)



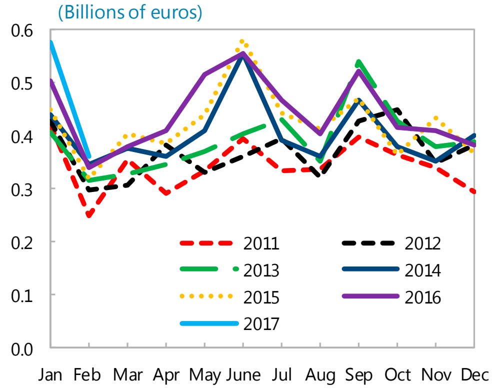
… and revenues slightly lower reflecting low EU grants.

Revenues
(Billions of euros)



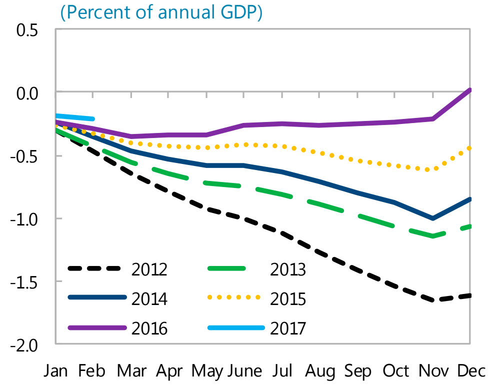
Taxes performed reasonably well.

Taxes
(Billions of euros)



Social Security benefitted from strong wage growth.

Cumulative Social Security Fund Deficit
(Percent of annual GDP)

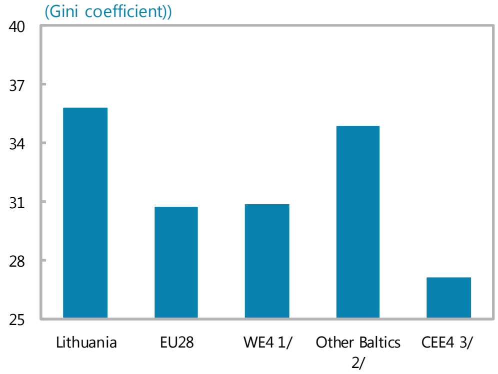


Sources: Ministry of Finance; and IMF staff calculations.
1/ Central Government Cash Balance comprises of State Budget, Extrabudgetary Funds, and Social Security Funds.

Figure 5. Republic of Lithuania and Selected Regions: Income Inequality, 2013–15 Averages

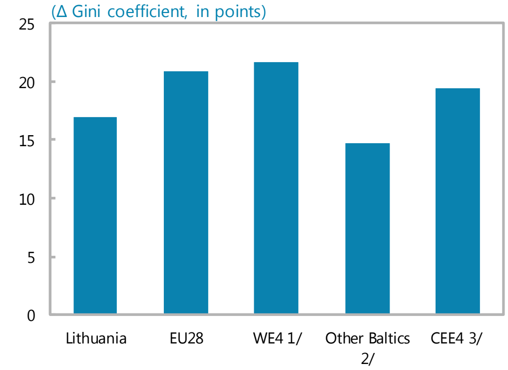
Income inequality is high …

Equalized Disposable Income after Tax and Transfers
(Gini coefficient))



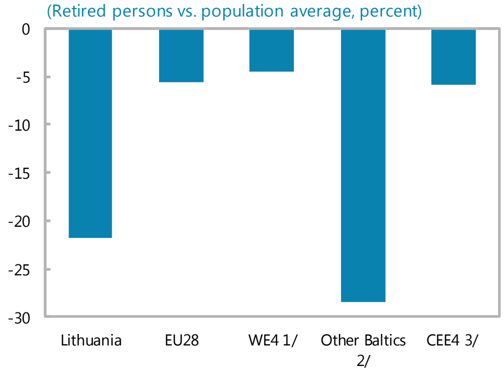
… partly because of fewer redistributive transfers.

Reduction of Income Inequality through Transfers
(Δ Gini coefficient, in points)



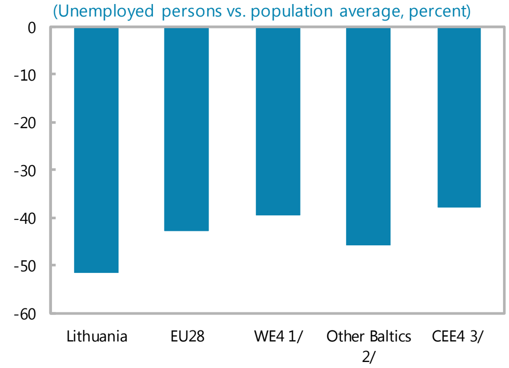
Retirement income is relatively low, …

Income Premium of the Retired
(Retired persons vs. population average, percent)



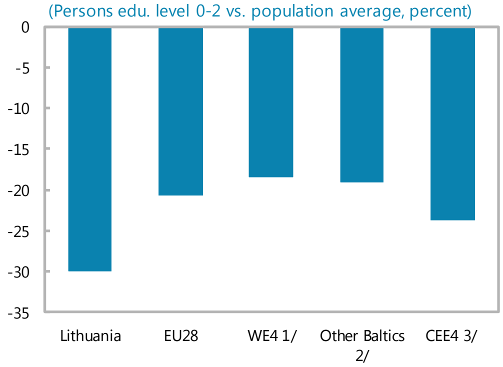
… so is the income of the unemployed, …

Income Premium of the Unemployed
(Unemployed persons vs. population average, percent)



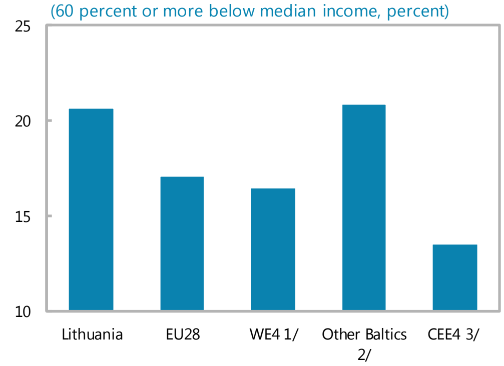
… and the poorly educated.

Income Premium of the Poorly Educated
(Persons edu. level 0-2 vs. population average, percent)



A relatively high share of the population is at risk of poverty.

Population Share At-Risk-Of Poverty
(60 percent or more below median income, percent)



1/ Simple average of France, Germany, Italy, and the UK.
2/ Simple average of Latvia and Lithuania.
3/ Simple average of the Czech Rep., Hungary, Poland, and Slovakia.
Sources: Eurostat; and IMF staff estimates.

Table 1. Republic of Lithuania: Selected Economic Indicators, 2014–22[1/]

Quota (current, % of total): SDR 441.6 million , 0.09 percent
Main products and exports: minerals (incl. refined fuel), agricultural and wood products, chemicals, plastics, textiles.
Key export markets: Russia, Latvia, Estonia, Poland, Germany

Per capita GDP (2016): € 13,500
Literacy rate (2015): 99.8%
At-risk-of-poverty (after transfers), share of population (2015): 29.3 percent

	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Projections					
Output									
Real GDP growth (annual percentage change)	3.5	1.8	2.3	3.2	3.2	3.2	3.1	3.1	3.0
Domestic demand growth (year-on-year, in percent)	3.4	6.7	2.7	3.4	3.6	3.7	3.5	3.5	3.4
Private consumption growth (year-on-year, in percent)	4.3	4.1	5.6	4.2	3.8	3.5	3.2	3.2	3.0
Domestic fixed investment growth (year-on-year, in percent)	3.7	4.7	-0.5	2.7	4.8	5.5	5.7	5.7	5.7
Inventories (contribution to growth)	-0.2	2.9	-1.0	0.0	0.0	0.0	0.0	0.0	0.0
Net external demand (contribution to growth)	0.2	-5.2	-0.5	-0.3	-0.5	-0.6	-0.5	-0.5	-0.6
Nominal GDP (in billions of euro)	36.6	37.3	38.6	41.0	43.2	45.5	48.1	50.9	53.7
Output gap (percent of potential GDP)	-0.1	-0.9	-0.8	-0.4	-0.1	0.0	0.0	0.0	0.0
Employment									
Employment (annual percentage change)	2.0	1.2	2.0	1.5	0.7	0.6	0.5	0.2	0.1
Unemployment rate (year average, in percent of labor force)	10.7	9.1	7.9	7.4	7.2	7.0	6.8	6.7	6.7
Average monthly gross earnings (annual percentage change)	4.5	5.1	7.9	7.6	6.0	5.6	5.6	5.6	5.5
Average monthly gross earnings, real (CPI-deflated, annual percentage change)	4.3	5.8	7.2	4.0	3.9	3.4	3.0	3.0	2.9
Labor productivity (annual percentage change)	1.4	0.6	0.3	1.7	2.5	2.6	2.7	2.9	3.0
Prices									
HICP, end of period (year-on-year percentage change)	-0.1	-0.2	2.0	3.0	2.0	2.2	2.5	2.5	2.5
GDP deflator (year-on-year percentage change)	1.0	0.2	1.2	2.7	2.0	2.2	2.4	2.5	2.5
HICP core, period average (annual percentage change)	0.7	1.9	1.7	1.9	2.0	2.2	2.4	2.4	2.4
HICP, period average (annual percentage change)	0.2	-0.7	0.7	3.4	2.0	2.2	2.5	2.5	2.5
General government finances 2/									
Revenue (percent of GDP)	34.0	34.8	34.5	35.3	36.8	36.4	36.4	36.2	36.1
Of which EU grants	2.7	1.9	0.8	1.3	2.3	2.0	2.0	2.0	1.9
Expenditure (percent of GDP)	34.6	35.0	34.2	35.8	36.7	36.4	36.5	36.3	36.2
Of which: Non-interest	33.1	33.5	32.8	34.2	35.0	34.8	34.9	34.8	34.8
Fiscal balance (percent of GDP)	-0.7	-0.2	0.3	-0.4	0.1	0.0	-0.1	-0.1	-0.1
Fiscal balance excl. one-offs (percent of GDP)	-1.1	-0.5	0.2	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1
Structural fiscal balance (percent of potential GDP) 3/	-0.9	-0.2	0.6	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
General government gross debt (percent of GDP)	40.5	42.7	40.2	38.3	36.3	34.4	32.7	30.9	29.4
Of which: Foreign currency-denominated	31.9	11.9	11.3	10.8	10.2	9.7	9.2	8.7	8.3
Credit									
Private sector credit (end of period, percent change)	-0.9	4.1	7.3	6.8	6.6	…	…	…	…
Long-term lending rate to private sector	7.0	8.0	6.6	…	…	…	…	…	…
Short-term lending rate to private sector	2.7	2.5	2.3	…	…	…	…	…	…
Balance of payments (in percent of GDP, unless otherwise specified)									
Current account balance	3.6	-2.3	-0.9	-1.6	-1.5	-1.8	-2.2	-2.4	-2.6
Exports of goods and services (volume change, in percent)	3.5	-0.4	3.5	4.3	3.9	4.1	4.2	4.4	4.4
Imports of goods and services (volume change, in percent)	3.3	6.2	3.9	4.5	4.3	4.6	4.6	4.8	4.8
Foreign direct investment, net	0.0	-1.9	0.2	-1.5	-1.7	-1.8	-1.9	-1.9	-1.9
Short-term debt at original maturity	22.6	26.9	40.2	40.2	38.6	36.4	34.2	31.9	29.8
Gross external debt 4/	69.8	75.9	86.4	84.1	80.5	76.5	72.4	68.5	64.8
Exchange rates									
Real effective exchange rate (2005=100, +=appreciation)	120.7	118.9	121.0	..	..	..	..	..	..
Exchange rate (euro per U.S. dollar, end of period)	0.81	0.92	0.95	..	..	..	..	..	..
Exchange rate (euro per U.S. dollar, period average)	0.75	0.90	0.90	..	..	..	..	..	..
Saving-investment balance (in percent of GDP)									
Gross national saving	22.3	17.6	15.5	15.4	15.5	15.4	15.4	15.8	16.1
Gross national investment	18.7	19.9	16.4	17.0	17.0	17.2	17.6	18.1	18.7
Foreign net savings	-3.6	2.3	0.9	1.6	1.5	1.8	2.2	2.4	2.6

Sources: Lithuanian authorities; World Bank; Eurostat; and IMF staff estimates and projections.

1/ Data are presented on ESA2010, and BPM6 manuals basis.

2/ The numbers for 2014 include 302 million euros (0.8 percent of GDP) in compensation payments for past pension cuts on accrued basis. The payments are spread over 2014-16, affecting the debt profile for these years. ESM contributions are spread over 2015-19 and also increase debt. Passive projections from 2016 onward; incorporate only announced budgetary measures; budgetary impact of further defense spending, wage compensation and their potential offsetting measures are not included .

3/ Calculation takes into account standard cyclical adjustments as well as absorption gap.

4/ Government external debt excludes guaranteed loans.

Table 2. Republic of Lithuania: General Government Operations, 2014–22[1]

(ESA 2010 aggregates, in percent of GDP)

	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Projections					
Statement of Operations									
Revenue	34.0	34.8	34.5	35.3	36.8	36.4	36.4	36.2	36.1
Revenue excluding EU grants	31.2	32.9	33.7	34.1	34.5	34.4	34.4	34.2	34.2
Tax revenue	16.3	17.2	17.6	17.5	17.6	17.6	17.6	17.6	17.6
Direct taxes	5.0	5.5	5.7	5.5	5.5	5.6	5.6	5.6	5.6
Personal income tax	3.6	3.9	4.0	3.8	3.8	3.9	3.9	3.9	3.8
Corporate income tax	1.4	1.5	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Indirect taxes	11.3	11.8	11.9	12.0	12.1	12.1	12.1	12.1	12.1
VAT	7.6	7.7	7.8	7.8	7.8	7.8	7.8	7.8	7.8
Excises	2.9	3.1	3.1	3.3	3.3	3.3	3.3	3.3	3.3
Other	0.8	1.0	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Social contributions	11.3	11.9	12.5	12.8	13.0	13.1	13.1	13.1	13.0
Grants	2.7	1.9	0.8	1.3	2.3	2.0	2.0	2.0	1.9
Other revenue	3.7	3.7	3.5	3.7	3.9	3.7	3.6	3.5	3.5
Total expenditure	34.6	35.0	34.2	35.8	36.7	36.4	36.5	36.3	36.2
Current spending	31.3	31.4	31.3	31.9	32.0	32.0	32.0	31.9	31.8
Compensation of employees	9.4	9.6	9.8	9.7	9.7	9.7	9.7	9.7	9.7
Goods and services	4.7	5.1	4.8	4.8	4.8	4.8	4.8	4.8	4.8
Interest payments	1.6	1.5	1.4	1.5	1.7	1.6	1.5	1.5	1.4
Foreign	1.3	1.2	1.1	1.3	1.4	1.3	1.2	1.2	1.1
Domestic	0.3	0.3	0.2	0.2	0.3	0.3	0.3	0.4	0.3
Subsidies	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Grants	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Social benefits	12.4	12.5	12.7	13.0	13.2	13.3	13.4	13.4	13.4
Other expense	2.0	1.3	1.2	1.5	1.3	1.3	1.3	1.2	1.2
Capital spending	3.3	3.5	2.9	3.9	4.6	4.4	4.5	4.4	4.4
Net lending (+) / borrowing (-)	-0.7	-0.2	0.3	-0.4	0.1	0.0	-0.1	-0.1	-0.1
Net lending (+) / borrowing (-) excl. one-offs	-1.1	-0.5	0.2	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1
Net acquisition of financial assets	3.4	0.9	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Domestic	3.2	-0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	0.1	1.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	4.0	1.2	-0.5	0.4	-0.1	0.0	0.1	0.1	0.1
Domestic	0.6	2.1	-1.9	0.4	0.4	0.4	0.4	0.4	0.4
Foreign	3.4	-0.9	1.4	0.0	-0.5	-0.4	-0.4	-0.4	-0.4
Financial Balance Sheet									
Financial assets	27.3	29.8	29.5	...	...	...	...	...	...
Currency and deposits	7.4	7.4	6.3	...	...	...	...	...	...
Securities other than shares	0.1	0.0	0.0	...	...	...	...	...	...
Loans	0.3	0.3	0.2	...	...	...	...	...	...
Shares and other equity	14.3	15.8	15.9	...	...	...	...	...	...
Other financial assets	5.2	6.4	7.1	...	...	...	...	...	...
				...	...	...	...	...	...
Financial liabilities	52.4	53.9	51.8	...	...	...	...	...	...
Currency and deposits	0.8	1.3	1.4	...	...	...	...	...	...
Securities other than shares	38.1	40.8	39.0	...	...	...	...	...	...
Loans	7.8	7.9	7.2	...	...	...	...	...	...
Other liabilities	5.6	4.0	4.3	...	...	...	...	...	...
Net financial worth	-25.1	-24.1	-22.3	...	...	...	...	...	...
Memorandum items:									
GDP (in millions of euros)	36,590	37,331	38,637	40,973	43,170	45,522	48,097	50,862	53,718
General government debt (Maastricht def.)	40.5	42.7	40.2	38.3	36.3	34.4	32.7	30.9	29.4
Foreign debt	29.6	30.9	31.2	29.4	27.3	25.5	23.8	22.1	20.6
Domestic debt	10.9	11.8	9.0	8.9	8.9	8.9	8.9	8.8	8.8

Sources: Ministry of Finance; Ministry of Social Security; and IMF staff estimates.

1/ Passive projections from 2016 onward. Projections incorporate only announced budgetary measures.

Table 3. Republic of Lithuania: Balance of Payments, 2014–22

(BPM6, Billions of Euros, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020	2021	2022
						Projections			
Current account balance	1.3	-0.9	-0.3	-0.6	-0.7	-0.8	-1.1	-1.2	-1.4
Merchandise trade balance	-0.9	-2.0	-1.9	-2.8	-2.9	-3.1	-3.4	-3.7	-4.1
Exports (f.o.b.)	23.7	22.3	21.9	25.6	27.0	28.3	29.7	31.4	33.3
Imports (f.o.b.)	24.7	24.3	23.8	28.4	29.9	31.4	33.0	35.1	37.4
Services balance	1.6	1.7	2.2	2.5	2.6	2.8	2.9	3.0	3.2
Exports	5.8	6.0	6.8	8.0	8.4	8.8	9.2	9.8	10.4
Imports	4.2	4.3	4.6	5.5	5.8	6.0	6.4	6.8	7.2
Primary income balance	-0.5	-1.6	-1.5	-1.3	-1.4	-1.5	-1.5	-1.6	-1.6
Receipts	0.8	0.7	0.8	0.9	0.9	0.9	1.0	1.1	1.1
Payments	1.3	2.3	2.3	2.2	2.3	2.4	2.6	2.6	2.7
Secondary income balance	1.1	0.9	0.8	0.9	1.0	1.0	0.9	1.0	1.1
Capital and financial account balance	1.8	-0.8	1.5	1.1	0.7	1.0	1.1	1.3	1.4
Capital account balance	1.0	1.1	0.6	0.9	0.9	1.0	1.0	1.1	1.1
Foreign direct investment balance	0.0	-0.7	0.1	-0.6	-0.8	-0.8	-0.9	-1.0	-1.0
Portfolio investment balance	-1.2	-0.2	3.4	0.3	0.4	0.4	0.4	0.4	0.4
Financial derivatives	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment balance	0.4	3.0	-4.3	0.2	0.6	0.5	0.4	0.3	0.3
Errors and omissions	-1.8	0.4	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	1.3	-1.3	0.8	0.4	0.0	0.2	0.1	0.1	0.0
Financing	-1.3	1.3	-0.8	-0.4	0.0	-0.2	-0.1	-0.1	0.0
Gross international reserves (increase: -)	-1.3	...	...	...	...	...	...	...	...
Use of Fund credit, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other prospective financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
In percent of GDP (unless indicated)									
Current account balance	3.6	-2.3	-0.9	-1.6	-1.5	-1.8	-2.2	-2.4	-2.6
Trade balance of goods and services	1.9	-0.7	0.8	-0.6	-0.6	-0.8	-1.0	-1.3	-1.7
Exports	80.9	75.9	74.3	81.9	82.0	81.5	80.9	81.0	81.3
Imports	79.0	76.5	73.5	82.5	82.6	82.3	81.9	82.3	83.0
Primary income	-1.4	-4.2	-3.8	-3.3	-3.2	-3.2	-3.2	-3.1	-3.0
Secondary income	3.1	2.5	2.0	2.3	2.3	2.2	1.9	2.0	2.0
Capital and financial account balance	4.8	-2.3	3.9	2.6	1.6	2.1	2.4	2.6	2.7
Capital account balance	2.7	3.0	1.5	2.2	2.1	2.2	2.1	2.1	2.1
Foreign direct investment balance	0.0	-1.9	0.2	-1.5	-1.7	-1.8	-1.9	-1.9	-1.9
Portfolio investment balance	-3.2	-0.5	8.7	0.6	1.0	0.9	0.9	0.8	0.8
Financial derivatives balance	0.0	-0.3	-0.1	0.0	0.0	0.0	-0.1	0.0	0.0
Other investment balance	1.1	7.9	-11.2	0.5	1.3	1.0	0.9	0.7	0.5
Overall balance	3.4	-3.5	2.1	1.0	0.1	0.3	0.1	0.2	0.1
Gross external debt 1/	69.8	75.9	86.4	84.1	80.5	76.5	72.4	68.5	64.8
Public	38.5	49.2	56.2	52.2	48.5	45.2	42.0	38.9	36.1
Short-term	3.5	12.5	22.3	20.7	19.1	17.7	16.3	15.0	13.7
Long-term	35.0	36.8	33.9	31.5	29.4	27.5	25.7	23.9	22.3
Private	31.4	26.7	30.1	31.9	31.9	31.3	30.4	29.5	28.7
Short-term	24.8	19.8	23.1	24.8	24.6	23.8	22.8	21.8	20.9
Long-term	6.6	6.9	7.0	7.2	7.3	7.5	7.6	7.7	7.8
Gross external debt (in percent of GS exports)	86.3	100.0	116.2	102.6	98.1	93.8	89.5	84.5	79.6
Net external debt	28.2	26.4	26.4	23.8	22.6	21.5	20.8	20.3	20.4
Net international investment position	-45.8	-44.7	-43.3	-41.8	-40.5	-39.5	-39.0	-38.6	-38.5
Merchandise export volume (percent change) 3/	3.5	-0.4	3.5	4.3	3.9	4.1	4.2	4.4	4.4
Merchandise import volume (percent change) 3/	3.3	6.2	3.9	4.5	4.3	4.6	4.6	4.8	4.8
Merchandise export prices (percent change) 3/	-2.6	-4.0	-2.0	12.1	1.4	0.7	0.7	1.4	1.5
Merchandise import prices (percent change) 3/	-3.4	-6.9	-4.3	14.0	1.1	0.4	0.6	1.4	1.6
GDP (in billion of Euros)	36.6	37.3	38.6	41.0	43.2	45.5	48.1	50.9	53.7

Sources: Data provided by the Lithuanian authorities; IMF International Financial and Trade Statistics; and IMF staff estimates and projections.

1/ Government external debt does not include guaranteed loans.

2/ Short-term debt at remaining maturity.

3/ Derived from national accounts data.

Table 4. Republic of Lithuania: Financial Soundness Indicators, 2011–16

(In percent, unless otherwise indicated)

	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16
Capital adequacy						
Regulatory capital to risk-weighted assets 1/ 2/	14.2	15.7	17.6	21.3	24.8	19.4
Regulatory Tier 1 capital to risk-weighted assets 1/ 2/	12.0	15.3	17.3	20.9	24.3	19.1
Capital to assets 1/	10.8	12.3	12.6	12.9	13.0	10.4
Asset quality						
Nonperforming loans to capital 1/ 3/	71.6	53.4	42.6	46.9	38.3	35.5
Nonperforming loans net of provisions to capital 1/ 3/	25.2	20.8	19.7	29.8	25.0	23.2
Nonperforming loans to total (non-interbank) loans 1/ 3/	16.6	14.8	11.6	7.0	5.7	4.1
	..	..	..	..	..	..
Nonperforming loans to capital 1/ 3/ 4/	71.6	53.4	42.6	46.9	38.3	35.5
o/w impaired loans to capital 1/ 3/ 4/	54.3	39.7	27.4	22.7	12.8	13.3
o/w non-impaired loans overdue more than 60 days to capital 1/ 3/ 4/	17.3	13.7	15.2	8.0	6.4	7.9
Nonperforming loans net of provisions to capital 1/ 3/ 4/ 5/	25.2	20.8	19.7	29.8	25.0	23.2
Nonperforming loans to total (non-interbank) loans 3/ 4/	16.6	13.6	11.0	7.0	5.7	4.1
o/w impaired loans to total (non-interbank) loans 4/	14.0	11.4	8.5	3.4	1.9	1.5
o/w non-impaired loans overdue more than 60 days to total (non-interbank) loans 4/	2.5	2.2	2.5	1.2	1.0	0.9
Impairment losses to total (non-interbank) loans 6/ 7/	7.0	5.6	4.2	2.5	2.0	1.4
Impairment losses to nonperforming loans 3/ 4/ 6/ 7/	64.9	61.0	53.7	36.5	34.7	34.7
Sectoral distribution of corporate loans 8/						
Agriculture, forestry and fishing	2.4	2.3	2.8	2.9	3.6	3.7
Mining and quarrying	0.4	0.6	0.5	0.5	0.5	0.5
Manufacturing	17.4	18.3	17.9	15.7	14.7	14.2
Electricity, gas, steam and air conditioning supply	5.0	6.8	7.6	9.5	11.0	8.7
Water supply; sewerage, waste management and remediation activities	0.7	0.7	0.8	1.0	1.0	0.9
Construction	12.8	10.4	8.6	7.3	6.1	5.4
Wholesale and retail trade; repair of motor vehicles and motorcycles	19.3	19.7	19.3	20.3	21.9	21.3
Transportation and storage	4.3	4.0	5.7	5.0	5.8	5.8
Accommodation and food service activities	2.8	2.8	2.7	2.6	2.4	2.4
Information and communication	0.9	0.8	0.8	0.9	0.8	2.4
Real estate activities	28.9	27.8	28.3	27.8	26.3	26.6
Professional, scientific and technical activities	2.8	4.0	2.6	3.7	2.6	3.2
Administrative and support service activities	1.1	0.9	1.0	1.8	2.0	3.0
Remaining activities	1.2	1.1	1.2	1.1	1.3	1.8
Residential real estate loans to total (non-interbank) loans	36.7	37.9	38.0	28.7	29.8	31.3
Earnings and profitability						
RoE 1/ 9/	15.8	8.9	10.1	9.7	8.8	12.9
RoA 9/	1.4	1.1	1.2	1.3	1.2	1.5
Interest margin to gross income	58.7	41.1	24.3	19.0	17.1	12.0
Noninterest expenses to gross income	60.2	63.1	60.5	58.6	57.4	52.0
Trading and foreign exchange gains (losses) to gross income	4.0	9.9	9.9	9.4	7.9	11.4
Personnel expenses to noninterest expenses	40.6	38.2	38.3	37.4	41.2	42.6
Liquidity						
Liquidity coverage ratio	..	..	..	..	..	266.3
Liquidity ratio (liquid assets to current liabilities) 10/	44.1	41.2	41.2	43.6	..	..
Liquid assets to total assets 10/	23.7	23.9	24.0	29.3	..	..
Current liabilities to total liabilities 10/	58.8	67.7	73.1	81.6	..	..
Loan to deposit ratio in the banking sector 11/	137.9	127.9	121.5	101.6	98.6	99.0
Foreign exchange risk						
Foreign-currency-denominated loans to total (non-interbank) loans 12/	72.4	71.6	68.7	..	..	..
Foreign-currency-denominated liabilities to total liabilities 12/	53.1	50.4	48.2	..	..	..
Net open position in foreign exchange to regulatory capital 1/ 13/	0.6	0.3	0.4	0.4	0.1	0.0
Memo item						
Provisioning (in percent of NPLs)	26.3	21.3	16.5	..	..	..

Sources: Bank of Lithuania; and http://fsi.imf.org/.

1/ Excluding foreign bank branches.

2new/ As defined in Rules for Calculation of Capital Adequacy approved by Bank of Lithuania Board Resolution No. 138 of 9 November 2006.

3/ Consolidated data are used. Due to changes in consolidation methodology, data from Q1 2014 are not entirely comparable with previous.

2015 Q3 - 2016 Q1 data were adjusted eliminating accounting changes due to the transaction between Swedbank, AB, and Danske Bank A/S Lithuania Branch.

4/ From end-2005 to Q1-2008, NPLs are loans overdue more than 60 days. Untill 2004 NPLs are loans in Substandard, Doubtful and Loss loans categories.

Starting June 2008, non-performing loans are defined as the sum of impaired loans and non-impaired loans that are overdue more than 60 days.

5/ Specific provisions include allowances for both individually and collectively assessed loans.

6/ Specific provisions include provisions against general portfolio risk until end-2004. From end-2005, due to the change in definition of NPLs, specific provisions are not directly attributable to the NPLs. Therefore, the ratio may be negative.

7/ Specific provisions include allowances for both individually and collectively assessed loans.

8/ According to Nace 1 up to Sept 2011. Data according to Nace 2 thereafter.

9/ Total profits (losses) after tax. Interim quarterly results are annualised.

10/ Composition of liquid assets and current liabilities is defined in the Liquidity Ratio Calculation Rules approved by Resolution No. 1 of

11/ Consolidated data; due to changes in data consolidation methodology, data from Q1 2014 are not entirely comparable with previous data.

12/ The large majority of foreign currency loans and foreign currency liabilities are in euros, to which the national currency is pegged via a currency board arrangement.

13/ As defined in Rules for Calculation of Capital Adequacy approved by Bank of Lithuania Board Resolution No. 138 of 9 November 2006.

Annex I. Public Sector Debt and External Sustainability Analysis (DSA)

Republic of Lithuania: Public DSA—Baseline Scenario

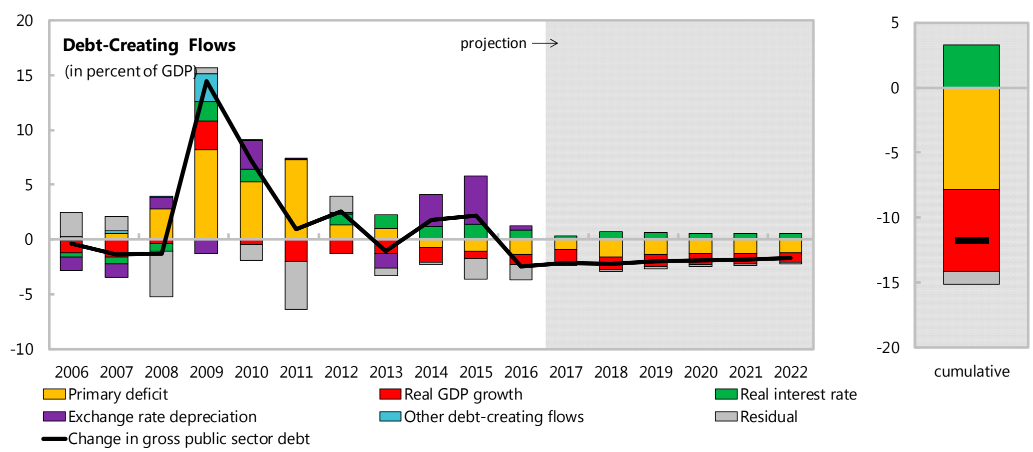
(in percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of March 27, 2017		
	2006-2014 [2/]	2015	2016	2017	2018	2019	2020	2021	2022	Sovereign Spreads		
Nominal gross public debt	29.9	42.7	40.2	38.1	35.8	33.8	31.9	30.1	28.4	EMBIG (bp) 3/		43
Public gross financing needs	8.5	6.6	5.9	4.1	5.6	3.0	3.5	2.5	4.2	5Y CDS (bp)		71
Real GDP growth (in percent)	2.8	1.8	2.3	3.2	3.2	3.2	3.1	3.1	3.0	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	3.8	0.2	1.2	2.7	2.0	2.2	2.4	2.5	2.5	Moody's	A3	A3
Nominal GDP growth (in percent)	6.9	2.0	3.5	6.0	5.4	5.4	5.7	5.7	5.6	S&Ps	A-	A-
Effective interest rate (in percent) [4/]	5.4	3.8	3.3	3.6	4.0	4.2	4.3	4.5	4.5	Fitch	A-	A-

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	2.5	2.2	-2.5	-2.1	-2.3	-2.0	-1.9	-1.8	-1.7	-11.8	
Identified debt-creating flows	3.1	4.0	-1.1	-1.9	-2.1	-1.8	-1.8	-1.7	-1.5	-10.8	
Primary deficit	2.8	-1.1	-1.4	-1.0	-1.6	-1.4	-1.3	-1.3	-1.2	-7.8	-0.3
Primary (noninterest) revenue and gra	34.0	34.5	34.2	35.2	36.6	36.2	36.2	36.1	36.0	216.3	
Primary (noninterest) expenditure	36.8	33.5	32.8	34.2	35.0	34.8	34.9	34.8	34.8	208.5	
Automatic debt dynamics [5/]	0.0	5.1	0.3	-0.9	-0.5	-0.4	-0.4	-0.4	-0.3	-3.0	
Interest rate/growth differential [6/]	-0.3	0.7	-0.1	-0.9	-0.5	-0.4	-0.4	-0.4	-0.3	-3.0	
Of which: real interest rate	0.5	1.4	0.9	0.3	0.7	0.7	0.6	0.6	0.6	3.3	
Of which: real GDP growth	-0.8	-0.7	-0.9	-1.2	-1.2	-1.1	-1.0	-1.0	-0.9	-6.3	
Exchange rate depreciation [7/]	0.2	4.4	0.4	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
LTU_FIS: Privatization Receipts (Nega	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euro	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	-0.6	-1.8	-1.4	-0.2	-0.2	-0.2	-0.2	-0.1	-0.1	-1.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

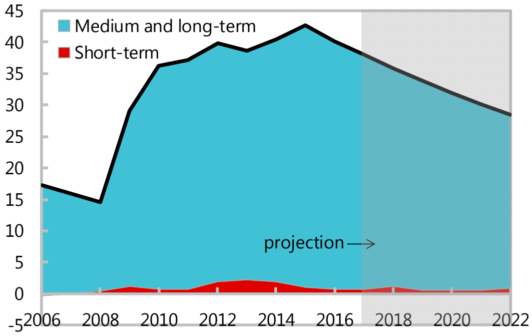
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Republic of Lithuania: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

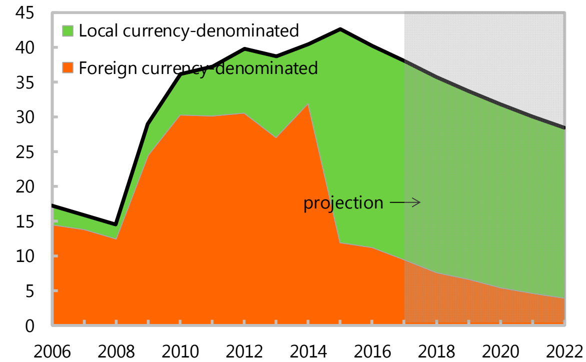
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

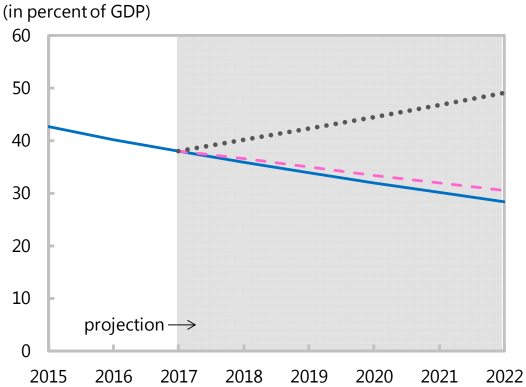


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

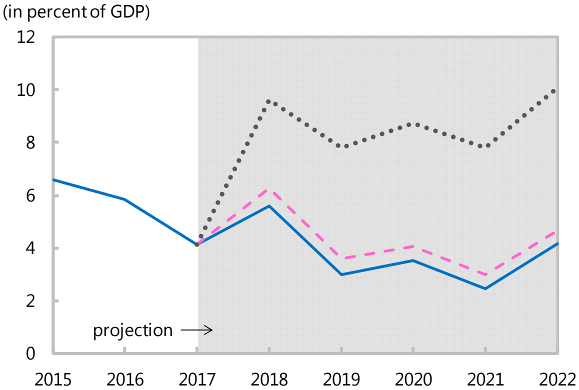
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.2	3.2	3.2	3.1	3.1	3.0
Inflation	2.7	2.0	2.2	2.4	2.5	2.5
Primary Balance	1.0	1.6	1.4	1.3	1.3	1.2
Effective interest rate	3.6	4.0	4.2	4.3	4.5	4.5
Constant Primary Balance Scenario						
Real GDP growth	3.2	3.2	3.2	3.1	3.1	3.0
Inflation	2.7	2.0	2.2	2.4	2.5	2.5
Primary Balance	1.0	1.0	1.0	1.0	1.0	1.0
Effective interest rate	3.6	4.0	4.2	4.3	4.5	4.6

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.2	2.2	2.2	2.2	2.2	2.2
Inflation	2.7	2.0	2.2	2.4	2.5	2.5
Primary Balance	1.0	-2.3	-2.3	-2.3	-2.3	-2.3
Effective interest rate	3.6	4.0	4.3	4.6	4.9	5.1

Source: IMF staff.

Republic of Lithuania: External Debt Sustainability Framework, 2012–22

(in percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2012	2013	2014	2015	2016			2017	2018	2019	2020	2021	2022	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	60.7	52.9	52.5	68.4	78.0			**79.2**	**76.0**	**72.2**	**68.3**	**64.8**	**61.6**	**-1.5**
Change in external debt	3.0	-7.8	-0.4	15.9	9.6			1.1	-3.2	-3.8	-3.9	-3.6	-3.2	
Identified external debt-creating flows (4+8+9)	1.9	-5.6	-4.7	13.0	-0.7			-0.4	-0.5	-0.1	0.8	1.1	1.3	
Current account deficit, excluding interest payments	-1.1	-2.8	-4.2	0.6	-0.5			0.6	0.6	0.9	1.5	1.6	1.7	
Deficit in balance of goods and services	-0.7	-0.9	-1.4	0.6	-0.8			0.6	0.6	0.7	1.0	1.2	1.6	
Exports	63.5	63.2	60.8	68.4	67.2			77.1	77.4	77.0	76.3	76.7	77.4	
Imports	62.8	62.3	59.4	69.0	66.4			77.7	78.0	77.7	77.3	77.9	79.0	
Net non-debt creating capital inflows (negative)	0.1	0.3	0.4	1.7	0.7			0.6	0.5	0.6	0.9	0.9	0.7	
Automatic debt dynamics 1/	2.9	-3.1	-0.9	10.7	-0.8			-1.5	-1.6	-1.6	-1.5	-1.4	-1.1	
Contribution from nominal interest rate	2.0	1.6	1.5	1.6	1.3			0.9	0.8	0.8	0.7	0.7	0.8	
Contribution from real GDP growth	-2.2	-2.0	-1.8	-1.1	-1.5			-2.5	-2.4	-2.3	-2.2	-2.0	-1.9	
Contribution from price and exchange rate changes 2/	3.2	-2.7	-0.6	10.3	-0.6			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	1.1	-2.2	4.3	2.9	10.3			1.5	-2.6	-3.7	-4.7	-4.7	-4.5	
External debt-to-exports ratio (in percent)	95.7	83.7	86.3	100.0	116.2			102.6	98.1	93.8	89.5	84.5	79.6	
Gross external financing need (in billions of US dollars) 4/	15.1	12.9	10.9	12.1	14.1			19.4	21.3	20.1	21.5	21.1	21.2	
in percent of GDP	35.1	27.8	22.3	29.2	33.0	10-Year	10-Year	44.5	46.6	41.7	42.2	39.3	37.5	
Scenario with key variables at their historical averages 5/								**79.2**	**78.2**	**76.5**	**73.8**	**70.9**	**67.9**	**0.1**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	3.8	3.5	3.5	1.8	2.3	2.2	6.6	3.2	3.2	3.2	3.1	3.1	3.0	
GDP deflator in US dollars (change in percent)	-5.2	4.7	1.2	-16.4	0.9	2.1	11.2	-1.4	1.7	2.2	2.5	2.2	2.0	
Nominal external interest rate (in percent)	3.5	2.9	2.9	2.5	2.0	3.4	1.0	1.2	1.1	1.1	1.0	1.1	1.2	
Growth of exports (US dollar terms, in percent)	16.1	8.0	0.7	-4.3	1.4	9.3	17.4	16.9	5.4	4.8	4.9	5.9	6.0	
Growth of imports (US dollar terms, in percent)	11.1	7.5	-0.2	-1.2	-0.6	7.8	19.3	19.1	5.5	5.0	5.2	6.3	6.5	
Current account balance, excluding interest payments	1.1	2.8	4.2	-0.6	0.5	-0.4	4.4	-0.6	-0.6	-0.9	-1.5	-1.6	-1.7	
Net non-debt creating capital inflows	-0.1	-0.3	-0.4	-1.7	-0.7	-0.7	0.7	-0.6	-0.5	-0.6	-0.9	-0.9	-0.7	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP c

3/ For projection, line includes the impact of price and exchange rate changes.

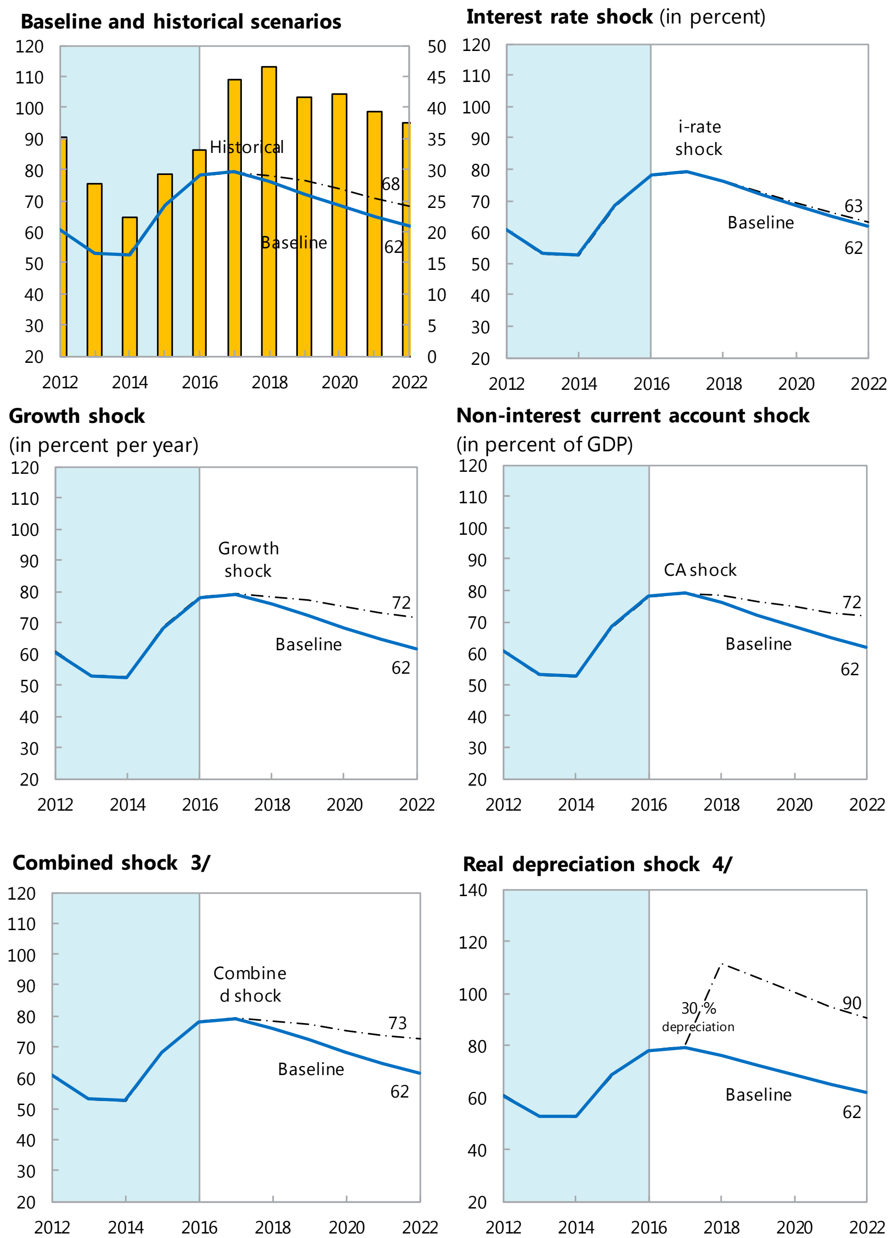
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Republic of Lithuania: External Debt Sustainability—Bound Tests 1/, 2/

(External debt in percent of GDP)



Sources: International Monetary Fund; country desk data; and IMF staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2010.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LITHUANIA

June 15, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | European Department

CONTENTS

FUND RELATIONS

(As of April 30, 2017)

Membership Status: Joined: April 29, 1992; Article VIII

General Resources Account:

	SDR Million	Percent of Quota
Quota	441.60	100.00
Fund holdings of currency (Exchange Rate)	441.58	100.00
Reserve Tranche Position	0.03	0.01

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	137.24	100.00
Holdings	137.29	100.04

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Aug 30, 2001	Mar 29, 2003	86.52	0.00
Stand-By	Mar 08, 2000	Jun 07, 2001	61.80	0.00
Stand-By	Oct 24, 1994	Oct 23, 1997	134.55	134.55

Projected Payments to Fund:

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2017	**2018**	**2019**	**2020**	**2021**
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

Implementation of HIPC Initiative: Not applicable.

Implementation of MDRI Assistance: Not applicable.

Implementation of Catastrophe Containment and Relief (CCR): Not applicable.

Exchange Rate Arrangement:

As of January 1, 2015, the currency of Lithuania is the euro, which floats freely and independently against other currencies. Prior to 2015, the currency of Lithuania was the litas. From April 1, 1994 to February 1, 2002, the litas was pegged to the U.S. dollar at LTL 4 per U.S. dollar under a currency board arrangement. From February 2, 2002 to Dec 31, 2014, the litas was pegged to the euro at LTL 3.4528 per euro. Lithuania joined the European Union (EU) on May 1, 2004, and ERM II on June 28, 2004. Lithuania has accepted the obligations of Article VIII of the Fund's Articles of Agreement and maintains an exchange system free of restrictions on the making of payment and transfers for current international transactions except for those maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

Previous Article IV Consultation:

Lithuania is on the 12-month consultation cycle. The last Article IV consultation was concluded on May 13, 2016. The Executive Board assessment is available at https://www.imf.org/en/News/Articles/2015/09/28/04/52/mcs031616 and the staff report and other mission documents at http://www.imf.org/external/pubs/cat/longres.aspx?sk=43901.0

Safeguards Assessment:

Under the Fund's safeguards assessment policy, the Bank of Lithuania (BOL) was subject to and completed a safeguards assessment with respect to the Stand-By Arrangement, (the SBA was approved on August 30, 2001 and expired on March 29, 2003) on December 10, 2001. The assessment identified certain weaknesses and proposed appropriate recommendations as reported in EBS/01/211. The BOL has implemented these recommendations.

FSAP Participation and ROSCs:

An FSAP Update mission was completed on November 19, 2007. Fiscal and statistics ROSCs were completed in November 2002 and December 2002, respectively.

Republic of Lithuania: Technical Assistance from the Fund, 1999–2016				
Department	**Issue**	**Action**	**Date**	**Counterpart**
STA	Balance of payments statistics (also covering Latvia)	Mr. Buxton	Resident Advisor, Oct. 1999–Oct. 2000	Bank of Lithuania
LEG	Bankruptcy legislation	Mr. Dimitrachkov	Mar. 2000	Ministry of Economy
FAD	Establishment of Fiscal Reserve Fund	Mission	Jul. 2000	State Privatization Fund
MAE	Multi-topic	Mission	Mar. 2001	Bank of Lithuania
FAD	Tax policy issues	Mission	Jun. 13–26, 2001	Ministry of Finance
STA	ROSC	Mission	May 8–22, 2002	Department of Statistics, Ministry of Finance, and Bank of Lithuania
FAD	ROSC	Mission	Jul. 10–23, 2002	Ministry of Finance
FAD	Treasury Operations	Mr. Ramachandran	Nov. 22–Dec. 5, 2004	Ministry of Finance
FAD	Decentralization	Mission	Dec. 3–Dec. 15, 2004	Ministry of Finance
STA	External debt statistics	Mission	Aug. 2–4, 2006	Bank of Lithuania
MCM	Stress testing	Mr. Miguel A. Segoviano Basurto	Jun. 11–21, 2007	Bank of Lithuania
STA	External debt statistics	Mission	Nov. 8–19, 2007	Bank of Lithuania
FAD	Public expenditure review	WB mission / Ms. Budina (FAD) participation	Apr. 14–24, 2009	Ministry of Finance
FAD	Tax Administration	Mission	Aug. 26–Sep. 8, 2009	Ministry of Finance
MCM/LEG	Bank Resolution/Banking Law	Mission	Sep. 28–Oct. 6, 2009	Bank of Lithuania/Ministry of Finance
FAD	Reform of Social Security and Health Funds	Mission	Apr. 6–20, 2010	Ministry of Finance/State Social Insurance Fund Board
LEG	Personal Bankruptcy Reform	Mission	Apr. 30–May 8, 2010	Ministry of Economy
FAD	Tax Administration	Mission	Jul. 14–27, 2010	Ministry of Finance
FAD	General Tax Policy	Mission	Oct. 19–25, 2010	Ministry of Finance
STA	GFS 2001 Statistics	Mission	Feb. 11–22, 2013	Ministry of Finance
MCM	Credit Unions	Mission	Nov. 18–29, 2013	Bank of Lithuania
MCM	Stress Testing	Mission	Dec. 16–18, 2013	Bank of Lithuania
FAD	Local Government Finance	Mission	Dec. 9–16, 2014	Ministry of Finance

Resident Representative:

None

Anti-Money Laundering (AML) and Combating Financing of Terrorism (CFT): Lithuania's compliance with the Financial Action Task Force (FATF) standard, was last assessed by MONEYVAL, the FATF-style regional body of which it is a member, in April 2012. The assessment report was published in December 2012. Lithuania was rated partially compliant on nineteen FATF Recommendations, leading to the application of the first stage of the Compliance Enhancing Procedure (CEP). In response, the authorities amended the Criminal Code and the AML/CFT Law and put in place secondary legislation and guidelines. This extended the list of punishable activities, criminalized financing of terrorism, reorganized the suspicious transactions reporting system, strengthened customer due diligence, and extended record keeping requirements. Lithuania has submitted to date three compliance reports under the CEP procedure. In recognition of the progress achieved in the key areas of concern, MONEYVAL ended the CEP at step 1 in April 2015, but recommended that the authorities address the remaining deficiencies and ensure effective implementation of its AML/CFT framework in order to exit the regular follow-up procedures. At the 50th Plenary meeting in April 2016, the Moneyval Secretariat acknowledged progress made by Lithuania but noted that further progress is needed with respect to R.5, R.13/SR.IV and SR.III. The last plenary meeting took place during May 30-June 1, 2017. While Lithuania has made progress on criminalizing ML/FT, it remains subject to regular follow-up. The authorities seek to exit in the context of the next full evaluation scheduled for the spring of 2018.

Lithuania is transposing the 4th Anti Money Laundering and Terrorist Financing Directive. The new legislation will improve the identification process of beneficial owners, broaden the definition of politically exposed persons, and strengthen the sanctions regime, among other improvements.

STATISTICAL ISSUES

General: Over the past several years, Lithuania has made good progress in establishing a macroeconomic database. Official data for all sectors are adequate for surveillance purposes. Lithuania subscribed to the Special Data Dissemination Standard (SDDS) in May 1996, and its metadata have been posted on the Fund's Dissemination Standards Bulletin Board (DSBB) since April 1997. Lithuania meets the SDDS specifications for coverage, periodicity and timeliness of the data, and for the dissemination of the advance release calendars. A significant amount of economic and financial information is now available on various websites through the Internet (see section on Dissemination of Statistics, below). A ROSC data module was published in November 2002. Data provision to the Fund for surveillance purposes is considered adequate.

National Accounts: The national accounts are compiled by Statistics Lithuania (SL) in accordance with the guidelines of the European System of Accounts 2010 (ESA 2010) from 2005 data onwards (data before 2005 still follow the European System of Accounts 1995, ESA 95). Quarterly GDP estimates at current and at constant prices are compiled using the production, expenditure and income approaches. GDP estimates by production are considered to be more reliable than the corresponding estimates by expenditure and income, but no statistical discrepancies between these three estimates are shown separately in the published figures as the discrepancies are included in the estimates of changes in inventories (expenditure approach) and operating surplus and mixed income (income approach). The annual and the quarterly national accounts are compiled at previous year prices and chain-linked to 2010. In general, good data sources and sound methods are used for the compilation of the national accounts, but measuring activity during the volatile environment of the 2008/09 crisis proved challenging. Moreover, difficulties remain in measuring the non-observed economy. These estimates are compiled at detailed levels of economic activity using fixed coefficients derived from a benchmark surveys conducted in 1996 and 2003, and updated in 2006, and in 2011. According to the most recent updates, the non-observed economy was estimated to be 28.5 percent of GDP in 2012.

Price Statistics: The main statistical data source for the production of the CPI is a monthly statistical survey on prices for consumer goods and services. Information published in the legal acts of state institutions, catalogues, pricelists, and on enterprises' websites is also used. The price survey covers the entire territory of the country, and data is collected in small, medium, and large towns. The CPI covers consumption expenditure of the residents of the country and is the main instrument of indexation. The authorities also produce the Harmonized Index of Consumer Prices (HICP) which is used to measure inflation in the EU and is fully comparable across countries. In addition to the consumption expenditure of residents, the HICP covers also consumption expenditure of non-residents and foreign visitors but excludes financial intermediation services and games of chance. Differences in coverage and hence weighting account for most of the differences in the value of the CPI and HICP. Since December 1998, CPI weights have been updated annually. The base period for the CPI is 2010 and for the HICP is 2005 (first year of data availability). The monthly CPI and HICP are available in the second week following the reference month. The producer price index is calculated according to the chain-linked Laspeyres formula with weights updated every year.

Government Finance Statistics: Data on the central government budget execution are available at a monthly and quarterly frequency. The ongoing treasury project is expected to improve fiscal data quality substantially. However, further work is needed to clarify the treatment of public health care providers and of EU transactions, and the consolidation procedure for government operations. A new methodology, incorporating the GFSM 2014, was adopted in October 2014. Annual and quarterly historical data have been converted into the GFSM 2014 format back to 2010, with data before 2010 still in the GFSM 2001 format. Administrative data sources include the Ministry of Finance, State Social Insurance Fund Board (Sodra), Compulsory Health Insurance Fund, Employment Fund, and financial statements of enterprises. The MoF is reporting to STA general government's annual data on an accrual and cash basis for publication in the Government Finance Statistics Yearbook (GFSY). In addition, the MoF is reporting quarterly and monthly data for publication in the IFS.

Monetary Statistics: The Bank of Lithuania (BoL) reports monetary and financial statistics (MFS) to STA on a timely and regular basis. The scope, concepts and definitions of the MFS are broadly in line with the guidelines of the Monetary and Financial Statistics Manual (MFSM). Following Lithuania's accession to the European Union, the BoL implemented the ECB framework for compiling and reporting monetary data reflecting the ECB regulations and ESA 2010 on sectorization, valuation and classification of financial instruments.

Balance of Payments: The BoL is responsible for compiling balance of payments, international investment position (IIP), external debt and international reserves statistics. The BoL reports quarterly data on balance of payments, IIP and monthly international reserves to STA on a timely and regular basis. Balance of payments data (on a monthly and quarterly basis) are compiled using the format recommended in the Balance of Payments Manual, sixth edition (BPM6) from 2004 data onwards (data before 2004 still follow the BPM5 methodology). The monthly data correspond to several key balance of payments components, compiled on the basis of a sample survey covering the public sector, commercial banks, and some nonfinancial private sector institutions. The Data Template on International Reserves and Foreign Currency Liquidity is disseminated monthly according to the operational guidelines and is hyperlinked to the Fund's DSBB. Since late 2004, the BoL disseminates quarterly external debt data in the World Bank's Quarterly External Debt Statistics (QEDS) database.

Data Standards and Quality: The authorities publish a range of economic statistics through a number of publications, including the SL's monthly publication, Economic and Social Developments, and the BoL's monthly Bulletin. A significant amount of data is available on the Internet:

- metadata for data categories defined by the Special Data Dissemination Standard are posted on the IMF's DSBB (http://dsbb.imf.org);
- the BoL website (http://www.lb.lt/statistical_data_tree) provides data on monetary statistics, treasury bill auction results, balance of payments, IIP, external debt and other main economic indicators;
- the SL website (http://osp.stat.gov.lt) provides monthly and quarterly information on economic and social development indicators;

- the MoF (http://www.finmin.lt) home page includes data on the national budget, as well as information on laws and privatization; and government finance statistics (deficit, debt);
- NASDAQ OMX Baltic website (http://www.nasdaqomxbaltic.com/market/?lang=en) includes information on stock trading at NASDAQ OMX Baltic stock Exchange in Vilnius (the former Vilnius Stock Exchange).

Republic of Lithuania: Table of Common Indicators Required for Surveillance

As of May 31, 2017

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:	
						Data Quality – Methodological soundness[8]	Data Quality – Accuracy and reliability[9]
Exchange Rates	May 31, 2017	May 31, 2017	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	April 2017	May 10, 2017	M	M	M		
Reserve/Base Money	April 2017	May 10, 2017	M	M	M	O, LO, LO, LO	O, O, LO, O, O
Broad Money	April 2017	May 10, 2017	M	M	M		
Central Bank Balance Sheet	April 2017	May 30, 2017	M	M	M		
Consolidated Balance Sheet of the Banking System	April 2017	May 30, 2017	M	M	M		
Interest Rates[2]	April 2017	May 10, 2017	M	M	M		
Consumer Price Index	April 2017	May 9, 2017	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4/2016	May 2, 2017	Q	Q	Q	LO, LO, LO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Q4/2016	May 2, 2017	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	March 2017	Apr 28, 2017	M	M	M		
External Current Account Balance	Q4/2016	May 5, 2017	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	March 2017	May 15, 2017	M	M	M		
GDP/GNP	Q1/2017	Apr 28, 2017	Q	Q	Q	O, LO, O, LO	O, LO, LO, LO, O
Gross External Debt	Q4/2016	Mar 23, 2017	Q	Q	Q		
International Investment Position[6]	Q4/2016	Mar 23, 2017	Q	Q	Q		

[1] Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means

[2] Both market-based and officially-determined, including deposit and lending rates, discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability position vis-à-vis nonresidents.

[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

[8] Reflects the assessment provided in the data ROSC published in July 2004, the findings of the mission that took place during September 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[9] Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.