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REPUBLIC OF LITHUANIA

September 2021

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF LITHUANIA

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 2021 Article IV consultation with the Republic of Lithuania, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its August 25, 2021 consideration of 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 August 25, 2021, following discussions that ended on June 14, 2021, 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 June 28, 2021.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Lithuania.

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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PRESS RELEASE

PR21/252

IMF Executive Board Concludes 2021 Article IV Consultation with the Republic of Lithuania

FOR IMMEDIATE RELEASE

Washington, DC – September 1, 2021: On August 25, 2021, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Lithuania.

Lithuania experienced the mildest contraction in Europe during the pandemic, benefiting from a strong starting position of the economy and a decisive policy response. Output fell by only 0.8 percent in 2020 compared to an average decline of 6.7 percent in the euro area. Growth recovered strongly in the third quarter of last year as containment measures eased, and momentum picked up in the first quarter of this year despite renewed containment restrictions. The impact on labor has varied across sectors—trade, transport and accommodation sectors were the hardest hit last year—with hours worked rather than employment absorbing most of the shock in the labor market.

For the first time, Lithuania was able to respond to a large negative shock with countercyclical policies, supported by large buffers in the economy and euro area membership. Improved fundamentals, large fiscal space and lower borrowing cost allowed for increased spending to support workers, businesses, and the healthcare system. Fiscal support relied largely on budget measures, in contrast to other countries that relied on off- budget and off-balance sheet measures. The Bank of Lithuania proactively eased countercyclical capital requirements, while the country benefited from accommodative ECB policies.

Output is expected to exceed pre-pandemic levels this year and surpass the pre-pandemic trend next year. Domestic demand is expected to drive the recovery, as pent-up demand and European funds are set to boost private consumption and investment.

[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.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities' decisive policies, which have contributed to the resilience of the economy during the COVID-19 pandemic and should help limit long-term economic scarring. Directors noted that the economy is poised for a robust recovery, supported by strong fundamentals, available policy space enabled by years of prudent policies, and sizeable grants from the European Union (EU). They stressed the need for continued vigilance, in light of the still high uncertainty, and for targeted support where it is most needed, while pressing ahead with priority reforms.

Directors agreed that fiscal policy should remain supportive and targeted at viable firms and households most affected by the pandemic. They recommended that, as the recovery advances, support should be withdrawn gradually in tandem with the pace of recovery. Directors highlighted the importance of rebuilding buffers to create space for social spending and investment in infrastructure and human capital. They saw the benefits of developing a comprehensive medium-term fiscal strategy to guide this effort, covering tax reforms and high-quality expenditure measures.

Directors encouraged proactive financial policies that balance supporting the recovery with safeguarding the resilience of the financial system. They agreed that further macroprudential actions may be necessary if signs of elevated risks emerge, particularly in the residential real estate sector. Noting the maturing Fintech sector, Directors emphasized the need to continue enhancing supervisory capacity and strengthening the AML/CFT framework.

Directors stressed the importance of implementing structural reforms to address long-standing economic and social challenges, including high poverty rates and regional disparities, which have increased budget rigidities. They agreed that the strong recovery and EU funds provide an opportunity to advance difficult reforms, including in education, healthcare, climate change, and digitalization. Directors also recommended prioritizing reforms to boost productivity, address demographic strains, and ensure continued convergence to euro area income levels.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

Lithuania: Selected Economic Indicators, 2020–26

Life expectancy at birth (2019): 81 years (women), 71.5 years (men)
Quota (current, % of total): SDR 441.6 million, 0.09 percent
Main products and exports: refined fuel, machinery and equipment, chemicals, textiles, foodstuffs, plastics, wood products.
Key export markets: Russia, Latvia, Poland, Germany, U.S.

Per capita GDP (2018): € 17,510
Literacy rate (2015): 99.8%
At-risk-of-poverty (after transfers), share of population (2019): 20.6%

	2020	2021	2022	2023	2024	2025	2026
		Projections					
Output							
Real GDP growth (annual percentage change)	-0.8	4.4	4.1	3.1	2.9	2.6	2.4
Domestic demand growth (year-on-year, in percent)	-5.2	7.0	6.8	4.9	4.0	4.0	3.7
Private consumption growth (year-on-year, in percent)	-2.0	6.4	5.9	4.4	3.6	3.4	3.4
Domestic fixed investment growth (year-on-year, in percent)	-0.2	10.8	10.6	7.0	5.8	5.9	5.0
Inventories (contribution to growth)	-3.8	0.0	0.0	0.0	0.0	0.0	0.0
Net external demand (contribution to growth)	4.2	-2.0	-2.3	-1.6	-1.1	-1.4	-1.3
Nominal GDP (in billions of euro)	48.9	52.4	56.0	59.2	62.3	65.3	68.2
Output gap (percent of potential GDP)	-0.9	0.3	0.9	0.6	0.4	0.2	0.0
Employment							
Unemployment rate (year average, in percent of labor force)	8.5	6.7	6.1	6.0	5.9	5.8	5.7
Average monthly gross earnings (annual percentage change) 2/	10.1	7.4	6.9	6.2	5.7	5.5	5.2
Average monthly gross earnings, real (CPI-deflated, annual percentage change)	9.0	4.0	4.1	3.5	3.2	3.2	3.0
Labor productivity (annual percentage change)	0.6	2.7	3.8	3.1	3.0	2.8	2.6
Prices							
HICP, period average (annual percentage change)	1.1	3.2	2.8	2.7	2.5	2.3	2.2
HICP core, period average (annual percentage change)	2.6	2.8	3.0	2.6	2.4	2.3	2.2
HICP, end of period (year-on-year percentage change)	-0.1	3.4	2.8	2.6	2.5	2.3	2.2
GDP deflator (year-on-year percentage change)	1.1	2.6	2.7	2.6	2.2	2.1	2.1
General government finances							
Fiscal balance (percent of GDP)	-7.4	-5.5	-2.9	-1.5	-1.1	-0.5	-0.4
Fiscal balance excl. one-offs (percent of GDP)	-7.4	-5.5	-2.9	-1.5	-1.1	-0.5	-0.4
Structural fiscal balance (percent of potential GDP) 1/	-6.3	-5.0	-2.8	-1.4	-0.9	-0.4	-0.3
Revenue (percent of GDP)	36.0	36.7	37.0	36.6	35.7	36.0	35.5
Of which EU grants	0.8	1.4	1.6	1.2	0.6	0.9	0.7
Expenditure (percent of GDP)	43.4	42.2	39.9	38.2	36.8	36.5	36.0
Of which: Non-interest	42.7	41.6	39.3	37.6	36.2	36.0	35.5
Interest	0.7	0.7	0.6	0.6	0.5	0.5	0.5
General government gross debt (percent of GDP)	47.1	47.8	45.9	44.3	42.5	40.5	38.6
Of which: Foreign currency-denominated	6.6	3.4	1.6	0.8	0.4	0.2	0.1
Balance of payments							
Current account balance (percent of GDP)	8.3	6.7	4.8	3.4	2.2	1.0	-0.3
Current account balance (billions of euros)	4.1	3.5	2.7	2.0	1.4	0.6	-0.2

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

Note: Data are presented on ESA2010, and BPM6 manuals basis.

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

REPUBLIC OF LITHUANIA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

June 28, 2021

KEY ISSUES

Context. With a demonstrated resilience to the crisis and the recovery gaining strength, macroeconomic policies should aim at preserving stability and complementing structural reforms that address long-standing challenges. A medium-term plan to rebuild buffers, support potential growth, and target pockets of vulnerability would help address pre-existing disparities and poverty. Sustained productivity growth, supported by the implementation of politically difficult but needed structural reforms, is the only way to support high wage growth and convergence with Western Europe. Failure to do so could jeopardize Lithuania's hard-earned competitiveness gains.

Key policy recommendations:

- **Support the recovery and preserve macroeconomic and financial stability:** Maintain targeted policy support in the short-term and proactively manage risks by maintaining countercyclical fiscal and macroprudential policies as the recovery strengthens. Ensure policies remain countercyclical, particularly if growth exceeds expectations, within the existing policy framework that has served Lithuania so well before the pandemic.
- **Target pockets of medium-term vulnerability:** With limited scarring expected, pockets of vulnerability should be supported with highly targeted measures while also facilitating a market-led reallocation of resources.
- **Implement structural reforms that support productivity growth:** Push strongly on the implementation of key structural reforms, including in education and healthcare, and utilize EU funds efficiently to enhance private sector productivity.
- **Reduce social disparities while raising potential output:** A credible medium-term fiscal plan that reflects the authorities reform agenda can help reduce social disparities, meet social demands, and improve outcomes.

Approved by
Philip Gerson (EUR) and Johannes Wiegand (SPR)

Discussions were held virtually in Vilnius during May 27–June 14, 2021. The team comprised Messers. Borja Gracia (head), Enrique Flores, Karim Foda and Ms. Yu Shi (all EUR). Mr. Marijus Bernatavicius (OED) participated in most of the meetings. Mr. Shituo Sun and Ms. Rafaela Jarin supported the mission from headquarters.

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CONTEXT: A RESILIENT ECONOMY AFTER YEARS OF STABILITY

1. **Lithuania entered the COVID-19 crisis in 2020 with ample buffers, strong growth, and years of prudent policies.** The macroeconomic and financial imbalances that built up before the Global Financial Crisis (GFC) had largely been corrected with stronger non-financial corporate and household balance sheets, a well-capitalized banking system and significant fiscal space. Unlike during the GFC, major foreign-owned banks are funded by domestic deposits rather than parents, the external and fiscal accounts have been in surplus, and euro area membership provided significantly lower borrowing costs and access to European Central Bank (ECB) facilities during the pandemic.

2. **A mild contraction in 2020 should allow the new government to complement short-term economic support with structural reforms to address long-standing challenges.** The strong starting position and decisive policy response to the pandemic resulted in a mild recession compared to other European countries and the GFC. A new coalition government was formed in December 2020. While the elections moved the political landscape to the center-right from the previous center-left coalition, big economic policy changes are not expected. The government has committed to continuing short-term policy support until the recovery becomes firmly entrenched, while preparing to address long-standing structural challenges that precede and extend beyond the immediate crisis. These include implementing critical education and healthcare reforms and boosting productivity to continue to support wage growth. With one of the highest old-age dependency ratios in the EU that is expected to double by 2060, strong productivity and wage growth is needed to mitigate or reverse negative demographic dynamics, and drive convergence.[1]

Text Table 1: Pre-GFC vs. Pre-COVID

	2007	2019
Current Account (percent GDP)	-13.1	5.2
Savings-Investment balances:		
Non-financial corporates	-9.0	5.8
Households	-4.2	-1.5
General government	-0.8	0.3
Financial corporates	0.9	0.6
Output gap (percent potential GDP)	13.4	0.8
Nominal wage growth[1]	19.3	8.8
Inflation[2]	11.2	2.2
Budget balance (percent GDP)	-0.8	0.5
Structural balance (percent potential GDP)	-6.4	0.6
Effective interest rate on public debt[3]	7.0	2.8

Sources: Eurostat, Haver, IMF staff calculations
1/ 2019 excludes tax and pension reform adjustment
2/ 2008 and 2019
3/ 2009 and 2019

GDP Growth
(Percentage change)

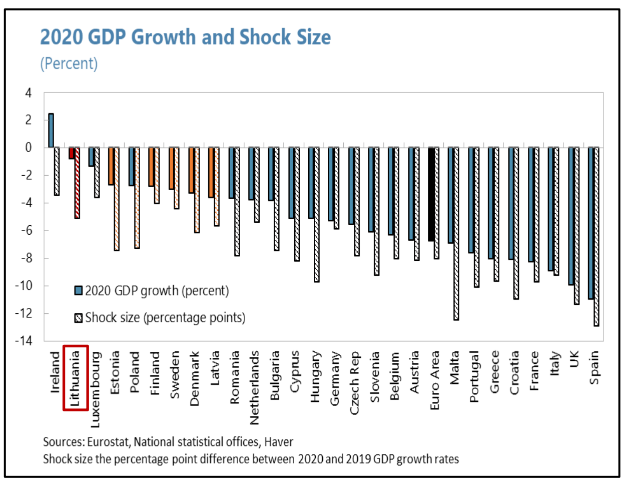
Sources: Eurostat; Haver
Note: Russia sanctions refer to the introduction of EU and US economic sanctions on Russia

[1] The 2019 Aging Report, European Commission.

RECENT DEVELOPMENTS: A MILD CONTRACTION WITH A DECISIVE POLICY RESPONSE

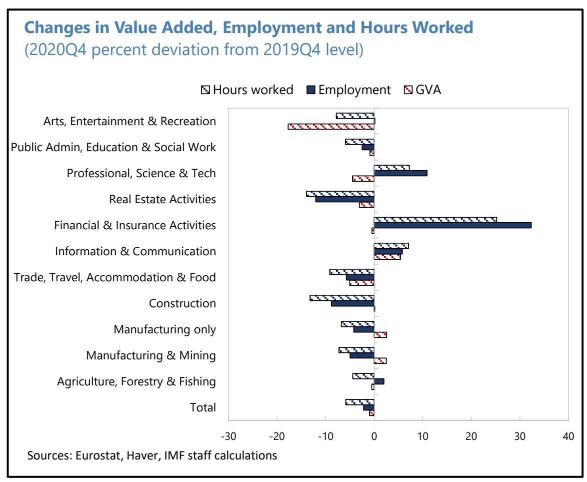
3. **Although the impact on growth was similar to other Baltic and Nordic nations, the Lithuanian economy experienced the mildest contraction in Europe in 2020.** The economy was in a strong cyclical position before the pandemic and without imbalances. Growth fell by 5.1 percentage points from 2019 to -0.8 percent in 2020. The contraction in the second quarter was followed by a strong recovery in exports and domestic demand in the third quarter (Figure 1). Overall, containment measures in 2020 were similar in nature to those implemented in most European countries but less stringent and shorter lived than in countries that were hardest-hit by the pandemic, supporting a V-shaped recovery in mobility (Figure 2). Notwithstanding remaining restrictions, economic activity continues apace in 2021 with better-than-expected growth in Q1 led by private consumption and higher frequency industrial production and confidence indicators.

4. **The impact of the shock due to the pandemic varied across sectors with hours worked absorbing most of it in the labor market.** The trade, transport and accommodation sectors—comprising around one third of output and over one quarter of employment in 2019—accounted for the largest contribution in the decline of total output and employment. Overall, most sectors responded with a larger adjustment in hours worked than employment, due in part to the government's support measures and jobs support schemes. Some service sectors with higher shares of teleworkable jobs expanded, including professional, science, and technology services.



2020 GDP Growth and Shock Size
(Percent)

Sources: Eurostat, National statistical offices, Haver
Shock size the percentage point difference between 2020 and 2019 GDP growth rates

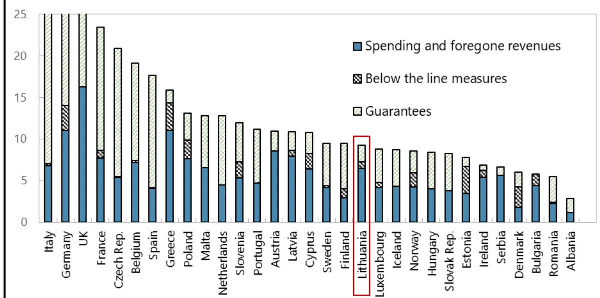


Changes in Value Added, Employment and Hours Worked
(2020Q4 percent deviation from 2019Q4 level)

Sources: Eurostat, Haver, IMF staff calculations

5. The policy response was decisively countercyclical for the first time during a big shock supported by large fiscal buffers and euro area membership. Improved fundamentals, large fiscal buffers and lower borrowing costs enabled the authorities to increase spending to support workers, businesses, and the healthcare system. The response relied more on budget measures, in contrast to other countries that relied more on off-budget and off-balance sheet measures such as loan guarantees. The Bank of Lithuania (BoL) proactively eased countercyclical capital requirements. As a member of the euro area, Lithuania benefitted from accommodative ECB policies (see Text Table 6).

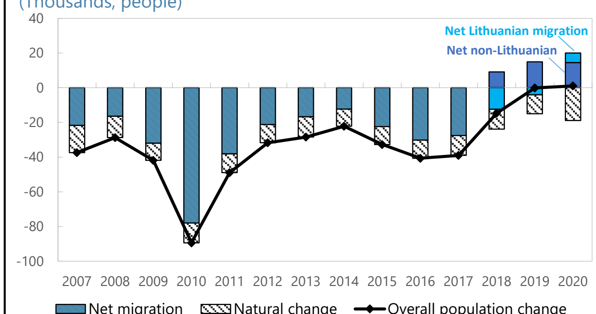
Announced Fiscal Support Measures
(Percent of 2020 GDP)



Source: IMF Fiscal Monitor Database, April 2021
Notes: Italy, Germany and UK reach totals of 42, 39, and 32 percents of GDP, respectively. Discretionary measures for 2020 and 2021. Below the line measures refer to equity injections, loans, asset purchases or debt assumptions. Accelerated spending and deferrals are not included.

6. Though unemployment rose, wage growth accelerated and the total population grew for the first time. The unemployment rate in 2020 increased by nearly one-fifth of the increase during the GFC. At the same time, wage growth accelerated, driven by both private sector wages, and previously planned public sector wage increases (Figure 3). Wage subsidy schemes helped mitigate employment and wage adjustments by firms, while other support policies like job search allowances helped incentivize informal workers to formalize as unemployed. Overall, the increase in the size of the (formal) labor force in 2020 was partly due to new unemployed entrants who explained almost half the increase in the unemployment rate, around 0.9 percentage points. However, with enhanced targeting of these measures, such as the job search allowance for unemployed workers this year, the labor force reverted back to pre-crisis levels, contributing a similar amount to the decline in the unemployment rate. Positive migration trends pre-crisis continued into 2020 when the total population increased for the first time, led by non-Lithuanian migrants and a positive net return of Lithuanian citizens, and supported by stable growth and rising incomes in recent years, Brexit and pandemic-related mobility restrictions.

Population Change and Migration
(Thousands, people)



Sources: Statistics Lithuania and IMF staff calculations

7. The external position was significantly stronger than fundamentals in 2020. The current account strengthened by 5 percent of GDP, driven by a sharp decline in fuel-related imports and in investment despite buoyant national savings reflecting temporary factors (largely precautionary and quarantine-related) rather than a long-term misalignment (see Annex II). Exports proved resilient to the pandemic given the modest reliance on tourism and strong agricultural and pandemic-related pharmaceutical exports. Freight on road transport exports also proved resilient, increasing by ¼ percent of GDP to 8.5 percent of GDP, despite the passage of the mobility package (see Box 1). Exports of financial and IT services increased foster by the growth of Fintech in the wake of Brexit.

Box 1. Lithuania: Mobility Package

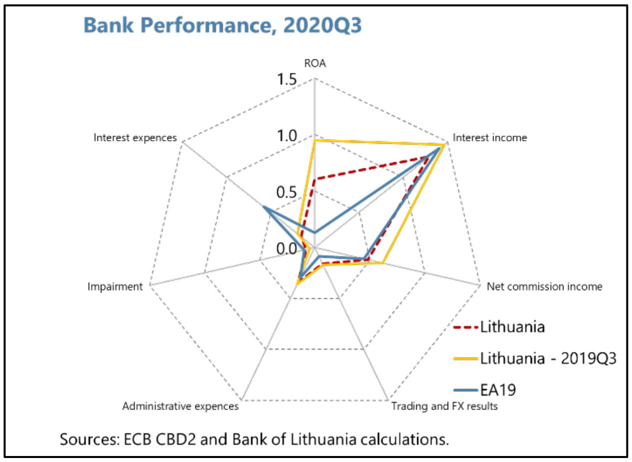
The European Commission (EC) adopted a set of initiatives related to transport and mobility known as the Mobility Package I in end-May 2017. In mid-2020, strengthened rules on driving times, breaks, and rest periods were approved. Two additional requirements—not part of the Commission's proposal—were also adopted, the compulsory return of vehicles to the companies' country of incorporation every eight weeks and the application of cabotage quotas on international combined transport operations. These requirements, which appear at odds with the spirit of the single market and the fight against global warming, are set to become effective by February 2022.

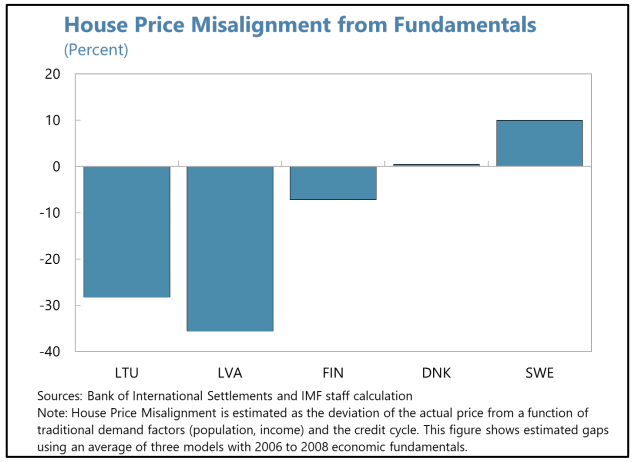
In mid-February, the EC published an impact assessment suggesting that the two additional requirements will likely have a negative impact on transportation costs as well as on the environment. The return obligation could potentially increase international EU road freight emissions by up to 2.9 million tons in 2023, while cabotage quotas could lead to an additional 0.4 million tons. Lithuania, with other countries, challenged these rules in the EU Court of Justice.

Road freight export services amounted to about €3.9 bn in 2020. So far there is no deterioration in those exports. The compulsory return and the cabotage quotas are expected to have an impact once they are implemented in early 2022. Based on the EU study and current figures on export services, staff estimates that the increase in costs due to additional journeys will be about 2¼ percent for Lithuanian operators.

8. **The financial system remains profitable, well capitalized and liquid, and positive real estate developments are estimated to be in line with fundamentals.** The banking sector continued to show strong financial soundness, with capital adequacy ratios well above the required minimum and ample buffers. The system's profitability and net interest income have declined compared to pre-pandemic levels, but they are still above peers in the euro area. Banking sector competition has further improved as the third largest bank has completed its restructuring and is in a position to be a more active market participant. Fintech companies are also raising competition particularly on the payments side and two more specialized bank licenses have been granted since 2020.[2] In this regard, the authorities have continued to strengthen the AML/CFT framework to minimize risks. Meanwhile, asset quality has not shown a significant deterioration. Non-performing loans (NPLs) to the non-financial corporate (NFC) sector have increased slightly but stayed below 2018 levels; NPLs to households have continued to decline against the backdrop of high-income growth supported by the policy response (Figure 4). Housing market developments have been positive since the second half of 2020, with house prices estimated to be in line with fundamentals.

[2] The capital requirements are lower and can provide most banking services except those related to investments, clearing, securities emissions, or pension funds.





9. The government's priorities are in line with Next Generation EU priorities and reflect pre-pandemic challenges, with an emphasis on climate change and digitalization. In particular, seven priority areas—education, healthcare, public sector reforms, innovation and science, social security, digitalization, and climate—reflect the government's medium-term plans, including allocation of resources with Next Generation EU funds. Lithuania is set to receive 2.2 billion euros (4.5 percent of 2020 GDP) over 2021–26 from the Recovery and Resilience Facility (RRF).

Text Table 2. Recovery and Resilience Funds 2021–2026

	Millions euros	Percent of total
Green Transformation	823.1	37%
Digitalization	448.3	20%
Education and Lifelong Learning	311.5	14%
Health Care System	268.0	12%
Higher Education and Innovation	200.2	9%
Social Protection and Employment	109.2	5%
Public Sector Restructuring	64.4	3%
Total	**2,224.7**	

Source: Ministry of Finance

OUTLOOK AND RISKS: SHORT-TERM UNCERTAINTY AND LACK OF STRUCTURAL REFORMS

10. Output is expected to exceed pre-pandemic levels this year and surpass the pre-pandemic trend next year. Domestic demand is expected to drive the recovery. Pent-up demand, reflected in a large build-up in deposits, and RRF funds are set to boost private consumption and investment. A rebound in imports will result in a negative contribution to growth from net exports. Recent positive migration trends are expected to partially continue as overall wage growth remains high. Over the medium-term, an expected modest improvement in demographics—along with support to investment from RRF funds—will help push actual and potential output levels above pre-pandemic trends.

Text Table 3. Macroeconomic Outlook

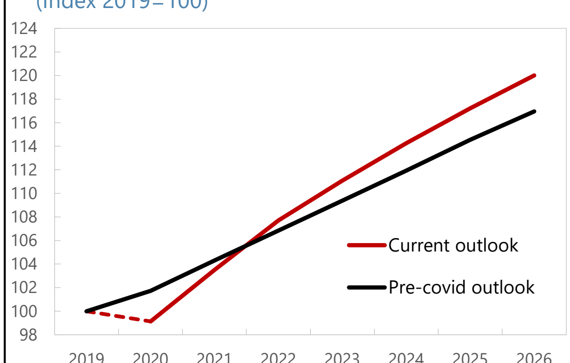
	2020	2021	2022	2023
GDP growth	-0.8	4.4	4.1	3.1
Domestic demand	-5.0	6.4	6.4	4.7
External demand	4.2	-2.0	-2.3	-1.6
Percent of 2019 GDP	99.1	103.5	107.7	111.1
Inflation	1.1	3.2	2.8	2.7

Source: IMF staff calculations. Projections begin in 2021.

11. Risks are broadly balanced in the short-term but with significant upside potential in the medium-term. Staff's assessment suggests limited or no scarring from the pandemic (section B below) and solid economic activity so far indicates that a rapid recovery is ongoing. On the upside, a rapid draw-down in deposits by households and businesses could spur rapid growth. In addition to stronger-than-expected recoveries in other countries driving external demand later this year, this could lead to higher inflation and a weaker current account. These developments could help correct the external position but, if sustained over time, could also lead to the reemergence of imbalances. On the downside, asynchronous recoveries among trading partners, geopolitical tensions, disruptions in the vaccination program, and delays in the absorption of RRF funds could weigh on growth (Box 2).

Real GDP Projections

(Index 2019=100)

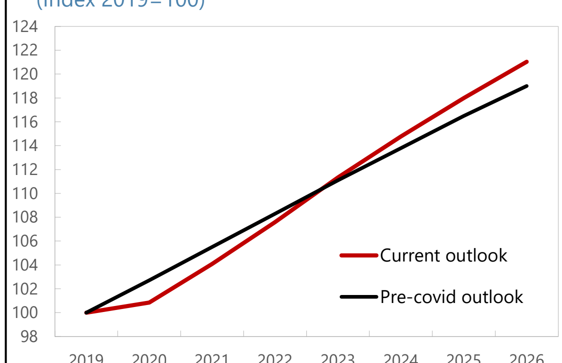


Source: IMF staff calculations

Notes: Pre-covid is based on projections made in the January 2020 World Economic Outlook.

Potential Output Projections

(Index 2019=100)



Source: IMF staff calculations

Notes: Pre-covid is based on projections made in the January 2020 World Economic Outlook.

Box 2. Lithuania: Risk Assessment Matrix[1]

Source of Risks, Likelihood, and Time Horizon	Impact on Lithuania	Recommended Policy Response
External Risks		
Medium **(short-term)** **Unexpected shifts in the COVID-19 pandemic: Prolonged pandemic.** The disease proves harder to eradicate, requiring costly containment efforts and prompting persistent behavioral changes rendering many activities unviable. Prolonged support exacerbates stretched asset valuations, fueling financial vulnerabilities.	Medium A prolonged decline in consumption and firm revenues could lead to increases in structural unemployment, though strong private and public sector balance sheets provide some resilience.	Continue fiscal and financial support to the real economy until an economic recovery is firmly entrenched and virus risks are controlled. Leverage EU funds to support employment and investment.
Medium **(short-term)** **Sharp rise in global risk premia exposes financial and fiscal vulnerabilities.** Higher risk premia generate financing difficulties for leveraged firms (including those operating in unviable activities) and households, and a wave of bankruptcies erode banks' capital buffers.	Low Low firm leverage, banks funded by domestic deposits, and moderate to low public debt levels should contain the impact on Lithuania. However, a sharp rise in borrowing costs could force a fiscal adjustment.	Maintain prudent lending standards and proactive macroprudential policy. Establish a credible medium-term fiscal strategy that includes plans for risk scenarios.
Medium **(short- to medium-term)** **Accelerating de-globalization.** Despite renewed efforts to reach multilateral solutions to existing tensions, geopolitical competition leads to further fragmentation. Reshoring and less trade reduce potential growth.	Medium 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.
Medium **(short- to medium-term)** **Cyber-attacks** on financial systems trigger systemic financial instability.	Medium Credit growth and investment could be impaired, though high liquidity in the economy could limit the impact.	Step up collaboration with home country supervisors and strengthen crisis preparedness.
Regional Risks		
Medium **(short- to medium-term)** **EU mobility package** leads to a significant market restructuring.	Medium Freight cross-trade and cabotage operations decline significantly, which would also impact tax revenues.	Strengthen safety nets and active labor market policies for affected households, while gradually tighten fiscal policy to regain fiscal space.
Domestic Risks		
High/Medium **(short-term)** **Significantly stronger than expected recovery leads to higher growth.** Pent-up demand and large build-up of deposits combined with very accommodative monetary conditions over the next two years drive a surge in domestic demand.	High/Medium Higher domestic demand will result in GDP exceeding pre-pandemic trends sooner than expected. While these dynamics could help correct the external position, if sustained over time it could lead to the re-emergence of imbalances.	Maintain a decisively counter-cyclical policy stance. Gradually tighten fiscal and financial policies while maintaining highly targeted support to vulnerable pockets of the economy.
Low **(medium-term)** **Risks to competitiveness.** Wage growth exceeds productivity growth in tradeable sectors for an extended period.	Medium Competitiveness and growth potential would suffer, and income convergence would stall. However, real wages and productivity have traditionally been closely linked and temporary deviations have been self-correcting.	Redouble efforts to implement structural reform programs. Avoid large minimum wage increases, minimize the public-private sector wage gap, and reduce skills mismatch.
High **(medium-term)** **Failure to implement structural reforms.** Elusive implementation of reforms in critical areas, including education and health care, limit opportunities to increase potential growth and productivity.	High Lithuania would be vulnerable to a middle-income trap and face continued social demands without commensurate growth and revenue.	Implement elusive structural reforms and a comprehensive medium-term fiscal plan that raises potential and meets social spending needs.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path. The relative likelihood is the 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 "high" a probability between 30 and 50 percent).

12. The authorities broadly agree with staff's assessment of the outlook and risks but highlight high uncertainty regarding the economic slack. They see a robust recovery developing this year and next led by domestic demand and strong exports. They also agree that investment from RRF funds will increase the growth potential of the economy along with higher value-added export composition. The Ministry of Finance believes that the crisis resulted in larger slack in the economy that will take longer to close. Over the medium-term, they agree that the external position will converge to the level implied by fundamentals.

POLICY DISCUSSIONS: SAFEGUARD STABILITY TO ADDRESS LONG-STANDING ECONOMIC AND SOCIAL CHALLENGES

With a demonstrated resilience to the crisis, macroeconomic policies should aim at supporting the economic recovery until it is firmly entrenched in the context of a strong and credible policy framework. A medium-term plan to rebuild buffers, support potential growth, and target pockets of vulnerability would help address pre-existing disparities exacerbated by the pandemic. The decisive implementation of critical structural reforms is the only way to achieve sustained productivity gains and support high wage growth going forward. Failure to do so could jeopardize Lithuania's hard-earned competitiveness gains and stalled convergence.

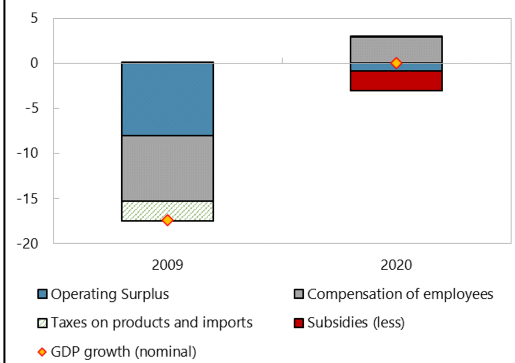
A. With the Recovery Underway, Safeguard Stability with Countercyclical Economic Policies

13. Lithuania has benefitted from a strong policy framework that has supported prudent policies and balanced growth after the GFC. These policies—along with euro area membership in 2015 and a flexible labor market—have helped provide stability and facilitate private sector growth in recent years without the reemergence of imbalances. The resulting fiscal and macroprudential space together with the response from the ECB have allowed for a decisively countercyclical response. The ECB's monetary policy stance was supportive of economic activity during the pandemic, but given the smaller economic contraction and stronger expected recovery in Lithuania than the rest of the euro area, it is expected to be looser than warranted for Lithuania alone going forward. In the absence of an independent monetary policy, available policy levers—particularly fiscal and macroprudential—should continue to be used proactively to preserve stability.

Fiscal Policies

14. The fiscal response to the pandemic was timely, appropriate, and provided substantial support to workers and businesses. In addition to an increase in health spending, policy measures, largely targeted, were introduced in 2020 to help preserve jobs, incomes, and businesses' liquidity and equity. With renewed lockdowns in 2021, many of these measures were extended (Text Table 5). Key measures include wage subsidies during and after national quarantines, benefits for selfemployed workers, job search allowances for the unemployed, deferral of social security contributions and sickness, disability, and extended child-care benefits. Businesses were offered liquidity support through tax deferrals, grants, subsidized direct loans, and guaranteed loans. Spending and revenue measures were the largest, including wage subsidies that reached over 15 percent of the working age population in 2020, and tax deferrals. In stark contrast to the GFC, the policy response now was able to support incomes throughout the economy as reflected in increasing overall wages and household's disposable income during the pandemic.

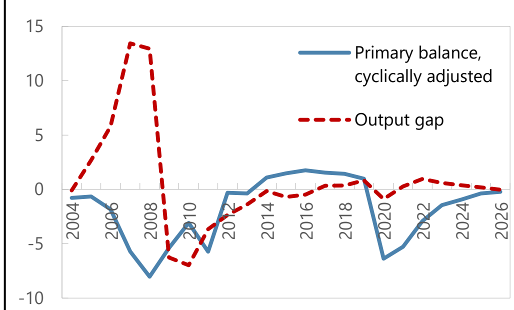
GDP Growth by Income Contributions (nominal)
(Percent change)



Sources: Haver, ECB, IMF staff calculations
Note: Total economy. Operating surplus and mixed income.

15. The 2021 budget allows fiscal support to continue as the recovery is underway. After a significant loosening of the fiscal stance in 2020 given the unprecedented level of uncertainty, the stance in 2021 is modestly tighter but with ample fiscal support in response to mobility restrictions earlier in the year. There were some eligibility criteria for most support measures that included—for example—a 30 or 60 percent drop in sales during periods of national quarantine to receive wage subsidies, the creation of an eligibility list of affected firms, or sector-specific grants or subsidized loans to travel service providers or agricultural firms. A temporary reduction in VAT rates for certain hard-hit sectors has also been introduced. Therefore, as the recovery takes hold, most discretionary measures are set to expire on their own.

Fiscal Position and Output Gap
(Percent of GDP and potential GDP)



Sources: IMF staff estimates and Ministry of Finance

16. The fiscal stance going forward will need to balance providing adequate support to a recovering economy while rebuilding fiscal buffers as the recovery gains strength. While staff estimates a closing output gap, this was partly achieved through the provision of significant discretionary fiscal support. Furthermore, there is still significant uncertainty about the size of the output gap and around future shocks. Therefore, the withdrawal of support needs to be gradual to avoid hurting the economy. Once the recovery is firm, greater emphasis should be placed on gradually rebuilding buffers, and more so if upside risks materialize (Annex IV).

17. Given the transitory and targeted nature of most support measures, little fiscal effort will be needed to place public debt on a downward trajectory over the medium-term. Debt is projected to increase from about 36 percent of GDP in 2019 to nearly 48 percent of GDP in 2021 before declining over the medium-term without additional policies and underpinned by favorable debt dynamics including low interest rates and stable growth (Annex III). Fiscal space remains substantial given low borrowing costs, moderate debt levels and enhanced market access. Independent of the pandemic, long standing challenges and increasing social demands remain and create spending pressures over the medium-term. Thus, developing a comprehensive medium-term fiscal strategy that addresses the government's priorities, sets an adequate fiscal path, and rebuilds buffers while adhering to national and EU fiscal rules is important.

Text Table 4. Assumptions on Absorption of RRF Funds (Percent of GDP)

	2020	2021	2022	2023	2024	2025	2026
Public debt	47.1	47.7	45.9	44.3	42.5	40.5	38.6
Overall balance	-7.4	-5.5	-2.9	-1.5	-1.1	-0.5	-0.4
Structural balance	-6.3	-5.0	-2.7	-1.4	-0.9	-0.4	-0.3
Revenues	35.1	36.0	36.7	37.0	36.6	35.7	36.0
o/w EU funds	0.8	1.4	1.6	1.2	0.6	0.9	0.7
o/w RRF funds	-	0.3	0.8	0.9	0.9	0.6	0.2
Expenditures	43.4	42.2	39.9	38.2	36.8	36.5	36.0
o/w RRF funds (new spending)	-	0.14	0.4	0.5	0.4	0.3	0.1
o/w RRF funds (other spending)	-	0.14	0.4	0.5	0.4	0.3	0.1

Sources: IMF staff estimates and Ministry of Finance

Notes: Structural balance measured as a percent of potential GDP. Total RRF funds amount to 2.2 billion euros over 2021-2026. Of those funds, half are assumed to be allocated to new spending and half to existing projects. Of new spending, one-third is allocated to goods and services and two thirds to capital spending.

Text Table 5. Key Discretionary Fiscal Support Measures (Percent of 2020 GDP)

	2020		2021 *(as of end-May)* *	
	Implemented	Planned	Implemented	Planned
Spending Measures	**3.6**	**4.6**	**1.2**	**3.0**
Jobs and Income support	**3.0**	**3.2**	**1.0**	**1.7**
Wage subsidies	1.7		0.5	
Child, sickness and other benefits	0.4		0.2	
One-off transfers to pensioners	0.4			
Self-employment benefits	0.3		0.2	
Job search allowance	0.3		0.1	
Business liquidity support	**0.3**	**0.4**	**0.2**	**0.5**
Interest compensation	0.05			
Lease fee compensation	0.1			
Micro-firm grants	0.2			
Subsidies to affected businesses			0.2	
Subsidies to most affected businesses			0.06	0.25
Health measures	**0.3**	**1.0**	-	**0.9**
Revenue Measures	**2.2**		**0.2**	
Tax deferrals ***(VAT, PIT, CIT)***	**1.9**		**0.2**	
Tax arrears	1.6		0.2	
Tax loans	0.3			
Social contribution deferrals	**0.3**		-	
Off-budget Liquidity Support	**0.6**	**1.4**	**0.1**	**0.1**
Lending ***(on balance sheet)***	**0.5**	**0.5**	**0.1**	**0.1**
Loans to affected businesses	0.4			
Direct loans to affected businesses			0.06	
Loans for payable invoices	0.02			
Loans for travel service and accommodation	0.03		0.01	
Guarantees ***(off balance sheet)***				
Portfolio COVID	**0.2**	**0.9**		
*Pre-existing schemes**	*0.3*			

Sources: Ministry of Economy and Innovation, INVEGA, Ministry of Social Security and Labor, Ministry of Finance, KoronaStop, and IMF staff calculations

*Includes 581 million euros in spending measures set to be approved after June 1.

**Limits on all new and pre-existing guarantee schemes (including on loans to the agricultural sector) increased to 1 billion euros for 2020.

Financial

18. Financial, macroprudential and ECB monetary easing have appropriately supported both the financial and non-financial private sectors. At the onset of the crisis, the BoL released the countercyclical capital buffer (CCyB) to support credit supply. As a euro area member state, Lithuania also followed ECB recommendations and eased prudential measures that are expected to remain in place in the foreseeable future. Private credit institutions agreed on two debt moratoria which provided further relief to hard-hit households and corporates.

Text Table 6. Key Monetary and Financial Sector Measures

Financial Sector Measures	
Easing of prudential and macroprudential measures	The countercyclical capital buffer (CCyB) requirement was lowered from 1% to 0%, and will remain at 0% until at least April 1, 2022
	Following ECB recommendations, BoL temporarily released the P2G requirement and provided flexibility in LCR requirement, the combined buffer (CCB + O-SII), as well as NPL strategies
Private debt moratoria	Encouraged by the BoL, private credit institutions applied debt moratoria for loan principal payments from April 20 to Sep 30, 2020. Corporate borrowers can postpone repayments up to 6 months; individuals can postpone leasing and consumer credits up to 6 months and mortages up to 12 months. The moratorium was renewed from Janurary 19 to March 30, 2021.
Monetary Policy Measures	
Monetary easing (ECB)	Temporarily eased conditions for LTRO and TLTRO III
	Expanded public sector purchasing program (PSPP)

Source: Bank of Lithuania

19. Bank losses related to the pandemic are expected to be small, and the banking sector is ready to support lending when the recovery takes place. Loans under EBA-compliant moratoria accounted for around 2.2 percent of household and 3.1 percent of NFC loan portfolios. More than 80 percent of these loans have exited the moratorium and were reclassified based on their underlying conditions. In addition, 0.4 percent of households and 3.8 percent of NFC loans have been restructured due to the pandemic following loan-by-loan standard processes, including proper classification and provisioning (Text Table 7). Given the limited coverage of the moratoria and little projected scarring (Annex V), pandemic-related losses are expected to be small. Loan-loss provisions increased significantly when the economic impact was expected to be much larger but have returned to more normal levels recently. Banking sector liquidity-coverage-ratio has increased by about 300 percent from already high levels in 2019 to become the highest among euro area countries, and loan-to-deposit ratio has reached an all-time-low. Households and NFC deposits surged by nearly 15 percent of GDP in large part due to the ample liquidity support from the government. This and the lack of business opportunities has resulted in a significant decrease in corporate borrowing. As economic uncertainty dissipates and loan demand resumes, the banking sector has the liquidity and capital position to support a strong economic recovery, even if the recent surge in liquidity proves temporary.

Text Table 7. Loans Restructured in Response to the COVID-19 Crisis

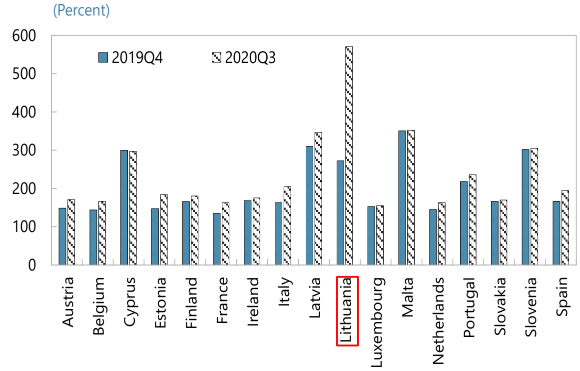
(in millions of euros)

	EBA-compliant Moratoria			Other COVID-19 Related Restructured Loans 1/		Total Loans
	Granted	Expired		Granted		(2021 Q1)
Households	253	180		49		11,424
Loan classfication		**Stage 2**	**NPL**	**Stage 2**	**NPL**	
		23%	1%	52%	39%	
NFC	234	227		289		7,544
Loan classfication		**Stage 2**	**NPL**	**Stage 2**	**NPL**	
		34%	3%	78%	15%	

1/ Followed the usual debt restructuring process and granted by banks on a loan-by-loan basis.
Source: Bank of Lithuania

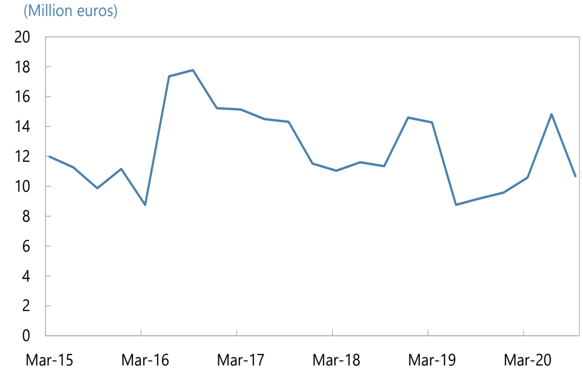
20. Financial sector policies should strike a balance between supporting credit in the short-term and maintaining longer-term resilience given potential financial stability risks. The second moratorium implemented in January through March 2021 provided more cashflow relief to stressed borrowers. In the absence of further restrictions to activity, the standard risk-management and asset valuation processes should be followed rather than broad based moratoria. Given that near-term uncertainty remains high, potential risks in the financial sector, including overheating in the housing market, particularly residential real estate, credit risk exposure to the most vulnerable

Banking Sector Liquidity Coverage Ratio
(Percent)



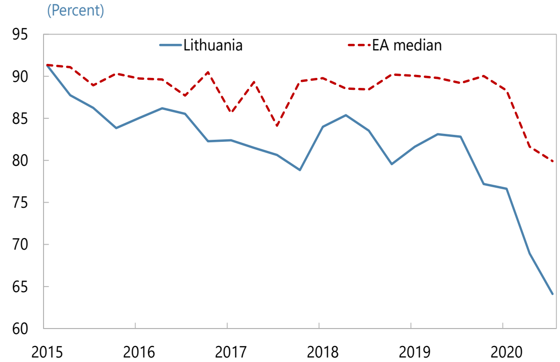
Source: European Banking Authority

Lithuania Level of Loan Loss Provisions
(Million euros)



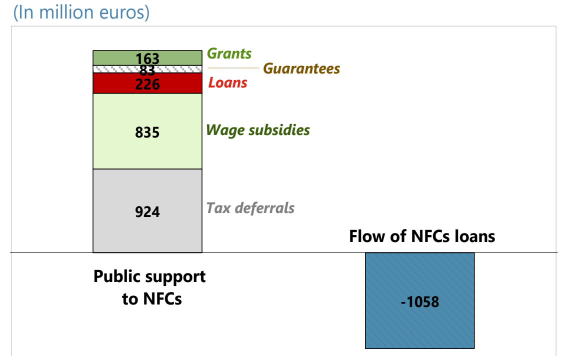
Sources: European Central Bank, Haver Analytics

Banking Sector Loan-to-Deposit Ratio
(Percent)



Sources: European Banking Authority and IMF staff calculations.

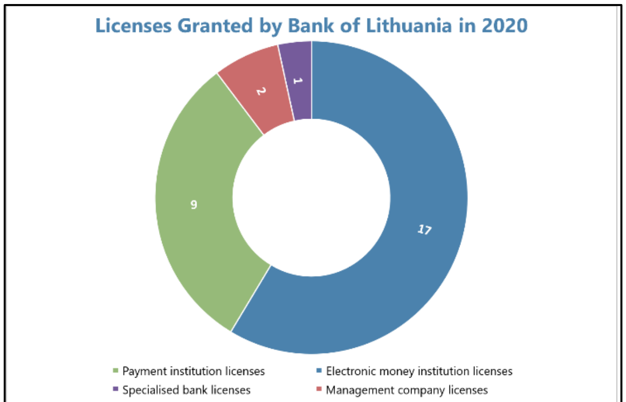
Public Support to NFCs and NFC Loan Flows, Mar.-Dec. 2020
(In million euros)



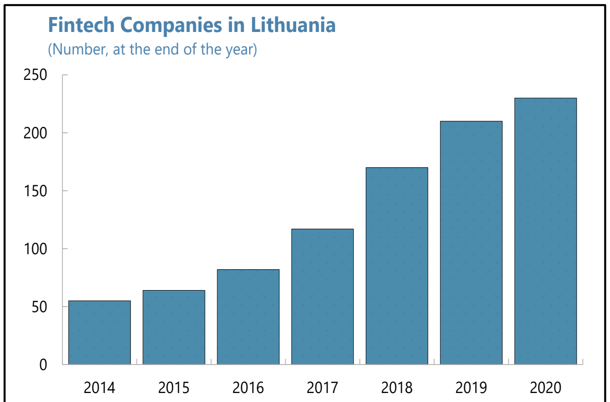
Source: Bank of Lithuania

borrowers, and other operational risks including cyber risks should continue to be monitored. Rebuilding macroprudential buffers such as targeted macroprudential tools or the CCyB will have to take place if signs of elevated risks in particular sectors start to emerge or upside macroeconomic risks materialize. When determining the use of these tools, the authorities should take into account that their effectiveness could be limited given the high liquidity and capital levels which are well above current requirements.

21. The Fintech industry quickly regained momentum during the pandemic, raising further challenges regarding AML/CFT, cyber risks, and supervision. Lithuania's supportive business environment and regulatory framework have attracted new players—both homegrown and from abroad—to its Fintech sector. As of end-2020, there were over 230 companies covering a wide range of businesses including digital banking, crypto currency, payment systems, etc. At the same time, the authorities have been proactively improving their AML/CFT framework and have established the Centre of Excellence in Anti-Money Laundering in collaboration with the private sector. The successful issuance of the digital collector coin LBCOIN will further strengthen the regulator's understanding in this area. Going forward, the expansion of online banks with a non-resident business model will create new supervisory challenges for which the BoL will need to proactively prepare.



Source: Bank of Lithuania

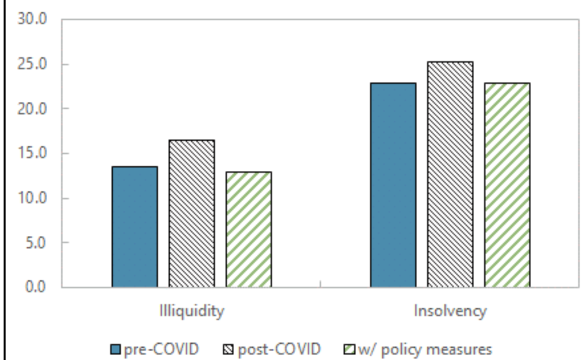


Source: Invest Lithuania

22. The authorities agree on the need to maintain countercyclical policies but highlight that heightened uncertainty warrants a cautious approach to the withdrawal of support. The Ministry of Finance's fiscal path reflects a greater estimated output gap that will only close next year resulting in larger fiscal support than projected by staff. They recognize high medium-term spending pressures given social demands and agree with the need to rebuild fiscal buffers. In this connection, they are already analyzing reforms into the tax policy framework consistent with these objectives. On the financial sector, the BoL emphasized that they will continue their proactive macroprudential policy stance and see potential short-term risks emerging in specific sectors such as residential real estate. Thus, they plan to address these risks, if needed, with targeted tools such as the sectoral systemic buffer that should have a lower social impact than adjusting borrower-based tools such as loan-to-value or debt-service-to-income ratios. Broader tools such as systemic risks buffers or the CCyB could be employed to respond to potential broader macroeconomic risks.

23. The authorities highlight the potential of a thriving Fintech sector and are actively working to minimize associated risks. They plan to continue efforts to strengthen the AML/CFT framework and supervision and highlight progress in implementing the 2018 MONEYVAL recommendations. They are aware of reputational risks and highlight that they favor quality over quantity in this area and will continue to take a rigorous supervisory and enforcement approach. They also emphasized that efforts in this area will be met with adequate resources as needed. A five-year inter-agency plan for the sector is currently being developed.

Share of Illiquid and Insolvent Firms
(percent)



Sources: Statistics Lithuania and IMF staff calculations

B. Target Pockets of Medium-Term Vulnerability and Address Disparities

24. Given the large policy response and lack of significant economic imbalances at the onset of the pandemic, permanent losses should be minimal (Box 3). With a mild recession in 2020, ample liquidity, resilient private sector balance sheets, and higher than expected EU funds in coming years, the economy is poised for a solid recovery once uncertainty dissipates. The big shock last year meant that household and corporations were at risk of developing large losses and the need for a post-crisis deleveraging process that would weigh on the recovery. However, the balance sheets of the public sector have largely absorbed private nonfinancial-sector losses that, in turn, isolated the financial sector preventing potential problems in the banking system (Box 4). Thus, preventing the pandemic crisis—exogenous and temporary in nature—from becoming a balance sheet recession appears to have been achieved by the policy support provided, including by the ECB, and the strong fundamentals of the Lithuanian economy.

Box 3. Lithuania: Channels of Economic Scarring

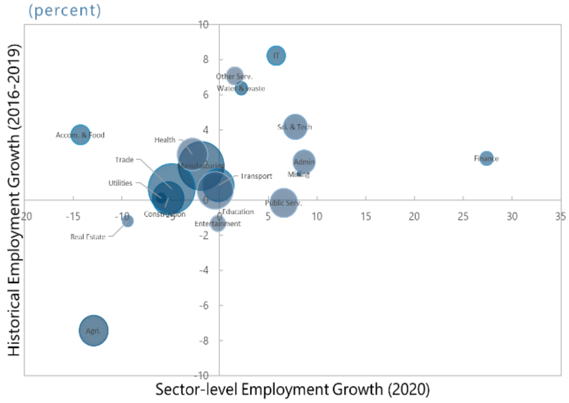
Economic crises could result in scarring through supply, demand, and policy channels.[a] On the supply side, the channels include persistently high unemployment in the labor market (labor market hysteresis), balance sheet disruptions of financial and non-financial corporates, exacerbated resource misallocation, and delay in human capital accumulation. On the demand side, household and corporate preferences could permanently change after a crisis, either through the shift in behavior or due to higher risk aversion. Finally, inadequate or delayed monetary and fiscal policy responses have been found to aggravate economic scarring in past crisis episodes.

[a] Shi and Suphaphiphat, "Economic Scarring from a Sectoral Perspective: Facts, Channels, and Policy Implications" (forthcoming, 2021)

25. Households and corporate liquidity and solvency have, on aggregate, not deteriorated during the pandemic, in sharp contrast to the experience during the GFC (Annex V). In fact, household net worth increased by 26 percent of GDP in 2020 and corporates reduced their leverage and improved their liquidity and solvency compared to 2019. In comparison to the GFC when the Lithuanian economy suffered larger permanent losses and significant balance sheet impairment resulted in a protracted recovery, this time corporates accumulated bank deposits and reduced their borrowing while households also accumulated bank deposits supported by relatively stable disposable income (Figure 5). Staff analysis estimates that announced policy support has resulted in a better solvency and liquidity positions of corporates than what would have been the case in the absence of the pandemic.

26. The impact of the pandemic on the labor market should also be largely transitory. Analysis based on earlier crisis episodes shows that job losses tend to have a larger permanent impact on employment in sectors with downward employment trends such as manufacturing (Annex V). In sectors with positive employment trends such as high-skilled services, employment tends to converge back to pre-shock trends. Thus, unlike the GFC where manufacturing was disproportionately affected, employment losses in other sectors, particularly high skilled services, should be largely temporary and limit scarring. Meanwhile, employment losses in sectors with little firm-specific human capital, such as food and accommodation that proved rather persistent after the GFC, should also be largely temporary provided the recovery quickly takes hold as expected.

Employment Growth by Sectors
(percent)



Sources: Lithuania Department of Statistics and IMF staff calculations.

GFC Employement Loss vs. COVID-led Jobs at Risk
(percent of total sectoral jobs)

Sources: Statistics Lithuania and IMF staff calculations

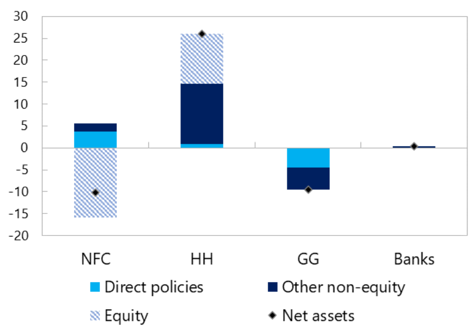
27. However, potential structural changes triggered by COVID-19 and remaining pockets of vulnerability could produce long-term economic losses (Box 3). While a balance sheet recession appears to have been avoided, sector-wide observations may mask pockets of vulnerability among firms in hard-hit sectors. Similarly, although it is too soon to know, the pandemic may trigger structural transformation and shifts in preferences that will require resource reallocation and transformation in the sectors involved. In this context, improvements in the insolvency regime and preserving the flexibility of the labor market will help facilitate a market-driven transformation.

28. The authorities broadly share staff's assessment of a moderate impact of the pandemic on Lithuania's corporate sector and labor market. They agree that remaining pockets of vulnerabilities in harder-hit sectors may need additional support that will have to be targeted at viable firms.

Box 4. Lithuania: Direct Policy Support to Private Sector Balance Sheets

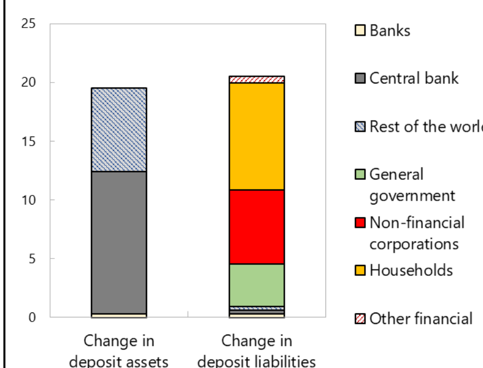
Fiscal policy support measures helped shift losses from private sector to public sector balance sheets. On aggregate, when an economic shock hits, the balance sheet impact can manifest itself in any sector and not necessarily where the shock first materialized (IMF 2021).[1] When the COVID-19 shock first hit NFCs and households, government policies stepped in to help absorb the impact. In Lithuania, the largest support measures came in the form of transfers to corporates through wage subsidies.[2] While corporates total net assets declined by 15 percent of GDP due to higher equity liabilities which also reduced leverage (Figure 5), non-equity flows had a positive impact on net assets by over 5 percent of GDP. In comparison, policy support to NFCs amounted to almost 4 percent of GDP, thus helping to bolster NFCs non-equity net asset position and supporting the decline in NFC leverage. The increase in household net assets was larger than the direct impact of policies, partly reflecting an increase in net equity assets, valuation effects (which in turn were impacted by policy support including ECB monetary policy interventions), and other benefits related to policy support to corporates that in turn supported employment. In total, households and NFCs increased deposits by over 15 percent of GDP.

Lithuania: Change in Net Assets: 2019Q4-2020Q4
(Percent of GDP)



Sources: Bank of Lithuania, National ministries, and IMF staff estimates
Note: Data directly from central banks may temporarily have more recent coverage for end-of-year financial accounts than ECB data.

Lithuania: Change in Banks' Deposit Assets and Liabilities: 2019Q4-2020Q4 (Percent of GDP)



Sources: Bank of Lithuania and IMF staff calculations

[1] "European Balance Sheets During the Pandemic: Who Bore the Brunt of the Shock?" (IMF 2021, forthcoming)
[2] Due to the challenges in assessing who the ultimate beneficiary is of a particular program, only the direct flow from the government or bank to the first recipient is recorded.

C. Structural Reforms to Ensure a Successful Convergence with Opportunities for All

29. Lack of structural reforms can derail Lithuania's ambitious agenda to address social disparities and heighten risks of a middle-income trap. To maintain hard-fought competitiveness gains and support wage growth to improve standards of living, it is critical to implement key structural reforms that enhance private sector led productivity growth and mitigate negative demographic dynamics. The risk of imbalances reemerging would grow if wages exceed productivity in the tradeable sector. So far, this has not been the case given high productivity in the price-taking export sector, with less productive non-tradable sectors absorbing higher labor costs by partially passing them on to consumers and reducing profit margins. This is a typical process in a converging economy and has helped increase the wage share in national income. Thus, supporting productivity growth in the export sector will help sustain recent high wage growth across all sectors (Box 5).

Box 5. Lithuania: Competitiveness, Wages, and Productivity

Since 2013, aggregate real wage growth has remained faster than productivity growth. Though sustained deviations between real wages and productivity have been self-correcting in the past (IMF Country Report No. 15/139), concerns around the erosion of Lithuania's competitiveness have grown. However, productivity growth in the manufacturing sector has preserved the economy's competitiveness and has supported wage growth in the rest of the economy.

According to Balassa-Samuelson, the prices of tradable goods equalize across countries whereas the prices of non-tradable goods are determined within countries. As labor is mobile across sectors, higher productivity and wages in the tradable sector leads to higher wages in the non-tradeable sector, above that sector's productivity.

Lithuania's experience is consistent with these predictions, and are even exceeded, as wages are equalized across sectors, and productivity levels in the tradeable sector are notably higher than wages (Figure 6). Past deviations between wages and productivity in manufacturing have not been sustained over time and the competitiveness gains after the GFC persist.

Overall, productivity in the export sector has made Lithuania competitive, increased its export market share faster than the other Baltic countries, and supported wage growth in the whole economy. These developments also suggest that investment in Lithuania, while lower than unsustainable pre-GFC levels, has gone to more productive activities (the land transport sector alone accounted for over 14 percent of all tangible investment from 2014-16, with the road cargo segment increasing its EU export market share by one-fifth each year over 2015-17 as it re-oriented its services towards the EU following EU and US sanctions on Russia (Bank of Lithuania Economic Review, September 2019)).

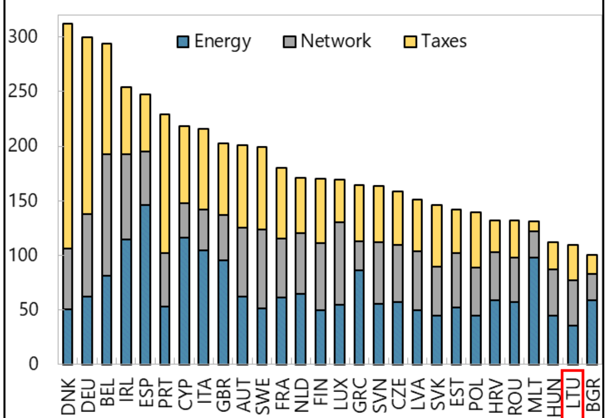
30. RRF plans can provide a needed impetus to implement difficult structural reforms and help drive public investments that support private sector productivity. The response to the pandemic as well as Next Generation EU and RRF funds can galvanize the required consensus around politically challenging reforms, particularly in education and healthcare. Further, these funds and low interest rates provide an opportunity to increase investment over the medium-term without jeopardizing the fiscal position. Public investment should aim at strengthening physical infrastructure and supporting growth in the high productivity professional services and information communications sectors.

31. Growing spending pressures to reduce high poverty rates and regional disparities have increased budget rigidities in recent years (IMF Country Report No. 19/252). Budgetary pressures will also come from lower projected replacement ratios for pensions, the most important redistributive tool available. Thus, further increases in social spending, which are below the EU average, will likely require more and better social programs. With discretionary spending already low, further increases in social spending cannot be financed without increasing revenues. Thus, a comprehensive fiscal strategy that incorporates plans to deal with these pressures and supports growth potential and productivity would complement qualitative reforms and, ultimately, help address social disparities (Annex VI).

32. Given poor outcomes in education and health, reforms in these areas, while politically difficult, are critical to support productivity and address social and regional disparities (Annex VI). Education and healthcare have proven to be the most difficult reform areas for past governments. On healthcare, public expenditures are comparable to EU peers but the share of out-of-pocket spending is 15 percentage points higher, suggesting a high burden of costs on patients that, nevertheless, face the lowest life expectancy in the EU. On education, spending on primary and secondary education is the second lowest among OECD countries and inefficiently focused on maintaining an excessive network that does not reflect demographic trends. Though enrollment is high, Lithuania is among the bottom 25 percent of EU countries in international PISA scores. Outcomes in tertiary education also lag behind with many fields that do not align well with labor market needs resulting in some graduates subsequently signing up for vocational training. This is reflected in Lithuania having the third highest level of skills mismatch in the labor market (IMF Country Report No. 19/253). The 2019 reform package included measures to help address these challenges, but implementation fell short as it lacked buy-in from municipalities.

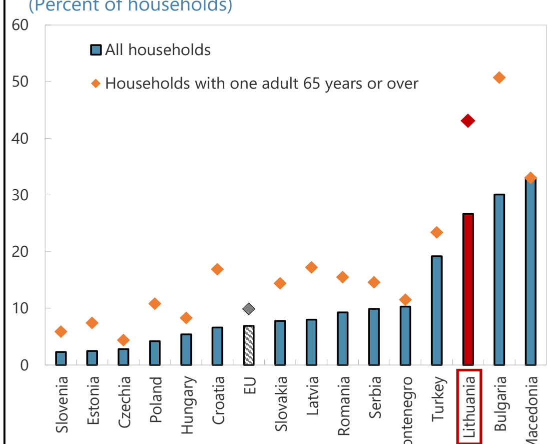
33. The government's climate and energy plans reflected in the draft Recovery and Resilience Plan are in line with EU goals, but their implementation will be challenging. Meeting national targets will require ambitious implementation plans that are currently being developed. Since 2005, greenhouse gas emissions have grown in line with GDP growth. Road transport is the leading driver of emissions and the dominant source of connectivity in the country. No carbon pricing in this and other non-ETS (Emissions Trading System) sectors is envisaged until other fuel-related tax exemptions are gradually phased out. Plans in this area will require consistency with other priorities, including reducing already high social disparities. For example, household electricity prices are among the lowest in the EU, but Lithuania has one of the highest shares of households unable to keep homes adequately warm, particularly among the elderly population.

Household Electricity Prices, 2018
(EUR/MWh; consumption band: 2,500–4,999 kWh)



Sources: Eurostat, IMF (2020) "Sectoral Policies for Climate Change Mitigation in the EU"

Share of Households Unable to Keep Home Adequately Warm
(Percent of households)



Sources: Eurostat, EU SILC survey

34. The authorities see the implementation of structural reforms as critical to increasing productivity growth and to creating the fiscal space needed to meet social demands. They stressed that rising spending pressures over the medium-term—including from social benefits and pensions in the context of a rapidly aging population—will require higher revenues and are reviewing their tax system to reduce loopholes and exemptions and improve its efficiency. In the areas of climate and digitalization, they acknowledge that their plans to meet national and EU targets are ambitious and will require significant resources but highlight that the long-term benefits far exceed these costs. In the areas of education and health, they recognize the political challenges but are hopeful that reforms in this area will be possible over the next few years. The authorities highlighted the benefit of RRF funds to help drive public investments that support private sector-led growth.

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35. Prudent pre-pandemic policies, a strong starting position and a decisive policy response have helped mitigate the economic impact of the pandemic. The stage is set for a robust recovery that will allow policymakers to refocus their attention on long-standing social and economic challenges. At the same time, Lithuania should maintain the proactive policy framework that has served the country well in the past.

36. The pace of withdrawal of fiscal policy support should depend on the strength of the recovery already underway. Fiscal support remains appropriate this year, but given better-than-expected economic developments, under staff's baseline a large share of support measures embedded in this year's budget may not be fully utilized. As the recovery becomes firmly entrenched, buffers should be rebuilt to secure Lithuania's capacity to respond to future shocks. If growth is stronger than expected, buffers should be rebuilt at a faster pace.

37. With minimal permanent economic losses expected, support should focus on specific pockets of vulnerability and facilitate a market-led reallocation of resources. Some individual, viable firms in sectors hardest-hit by the pandemic may need continued support for longer. Reaching them will require increasingly targeted measures. In this connection the temporary reduction of VAT is poorly targeted and may complicate revenue collection efforts.

38. Financial sector policies should continue to support the recovery while maintaining the resilience of the system against potential risks. The banking sector has ample liquidity and capital buffers to support a strong recovery. The positive developments in the housing market so far are estimated to be in line with fundamentals. However, if signs of elevated risks in particular sectors or overheating of the economy start to emerge, targeted macroprudential tools or reactivation of the CCyB will be necessary.

39. The external position was significantly stronger than implied by fundamentals in 2020. As the current account balance is projected to decline towards its norm, there is no concern of long-term misalignment.

40. **With a maturing Fintech sector, the focus continues to be on enhancing supervisory capacity and the AML/CFT framework.** As the sector becomes larger and increasingly sophisticated, the authorities need to address new challenges in order to realize its full potential and to reassure markets that risks remain contained. Progress in this area will require close multi-agency coordination and more resources but will help cement Lithuania's position as a European Fintech hub.

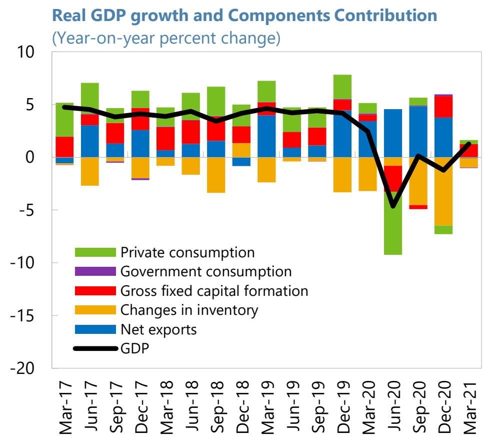
41. **Given rising budget rigidities and age-related spending pressures, further increases in social spending cannot be financed without higher revenues.** Reducing social disparities and poverty will require larger and more effective social programs. In this connection, a comprehensive fiscal strategy that incorporates a combination of revenue and high-quality expenditure measures should complement structural reforms.

42. **The combination of a strong recovery, new EU funds, and low funding costs, provides a unique opportunity to galvanize consensus around politically difficult reforms.** Public investment should aim to strengthen physical and human capital and support social cohesion. However, realizing the full benefits of reforms will require progress in all main areas simultaneously given their complementarity, particularly education and healthcare.

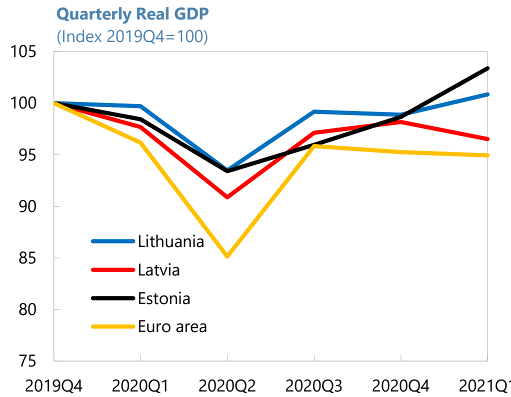
43. **The next Article IV Consultation is expected to be completed on the standard 12-month cycle.**

Figure 1. Lithuania: Macroeconomic Sector Developments

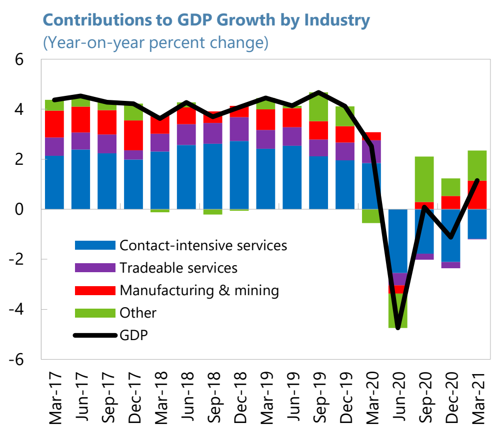
The shock to growth from the pandemic was mild…



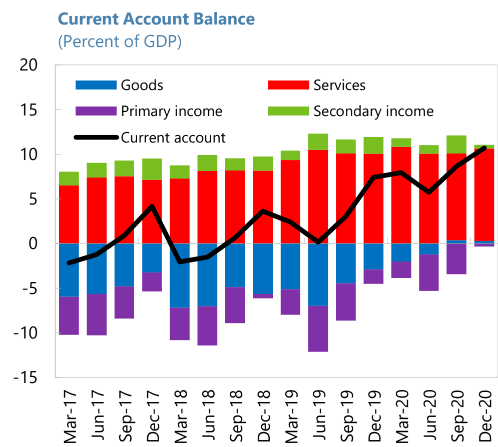
…and the rebound was faster and stronger than peers.



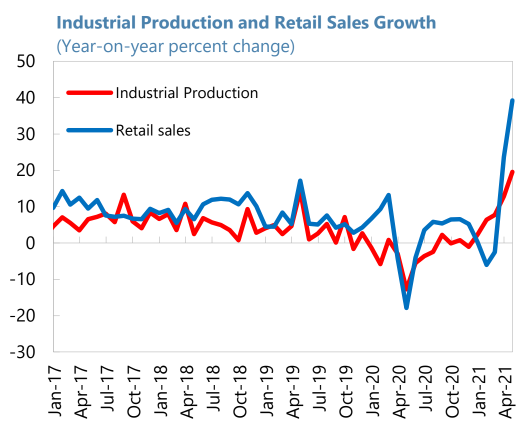
Contact-intensive sectors were hit harder than manufacturing and tradeable services…



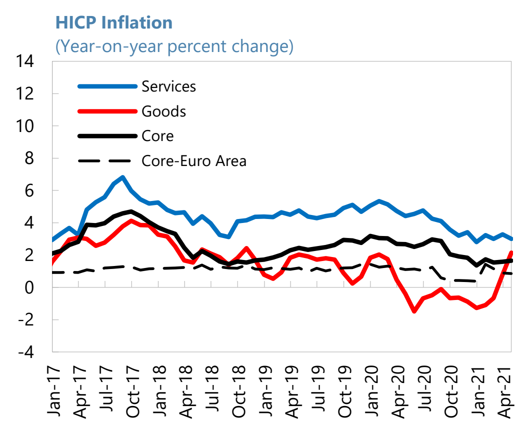
…leading to higher trade and current account balances.



Industrial production and retail sales quickly recovered.



Services kept core inflation elevated through 2020.

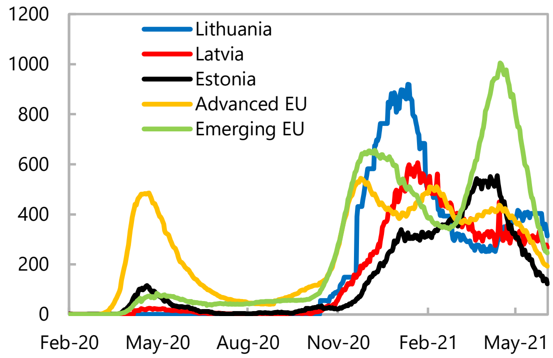


Sources: Haver; Lithuania Statistical Office; Bank of Lithuania; and IMF staff calculations.

Figure 2. Lithuania: Pandemic-Related Developments

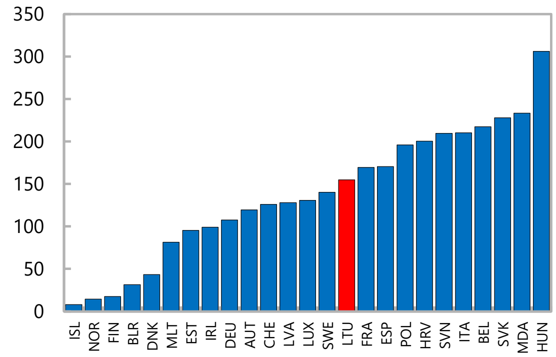
Lithuania was hit hard in the second wave of the virus.

Daily Hospitalizations Occupancy
(Patients per 1 million people)



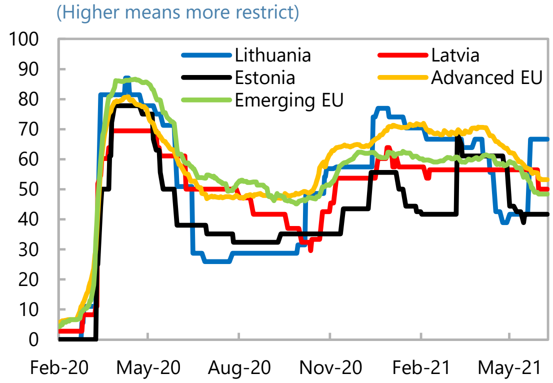
The human cost was high and in line with peers overall.

Cumulative deaths, as of June 10, 2021
(Per 100k people)



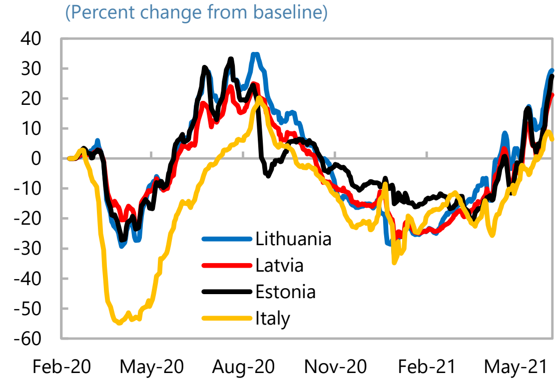
Containment measures were less stringent in mid-2020…

Stingency index
(Higher means more restrict)



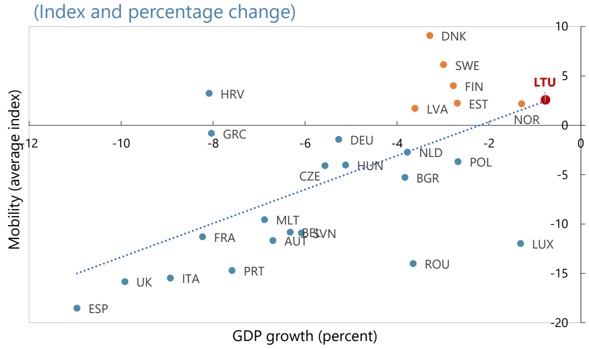
…facilitating a V-shaped recovery in mobility in 2020…

Mobility
(Percent change from baseline)



…that correlated with higher GDP growth.

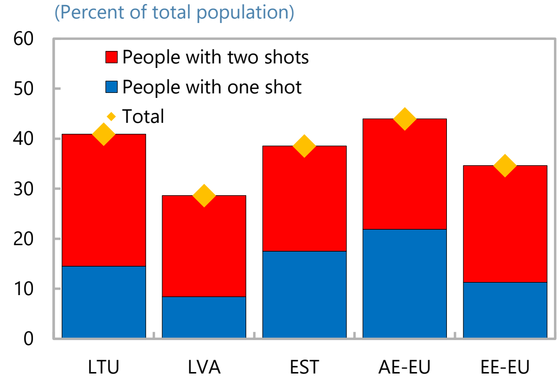
2020 Mobility and GDP Growth
(Index and percentage change)



Mobility index is a simple average of six sub-indices (retail, groceries, parks, transit, workplaces and residential. Index values are relative to mobility during Jan. 6 - Feb. 15 2020. Average mobility index is from Feb. 16 - Dec. 31 2020).

Vaccinations have advanced in line with the EU.

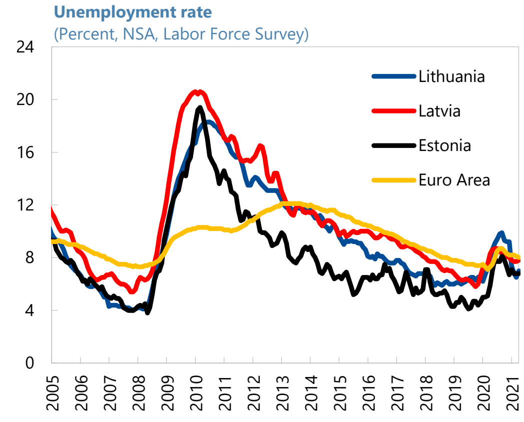
Vaccinations, as of June 10, 2021
(Percent of total population)



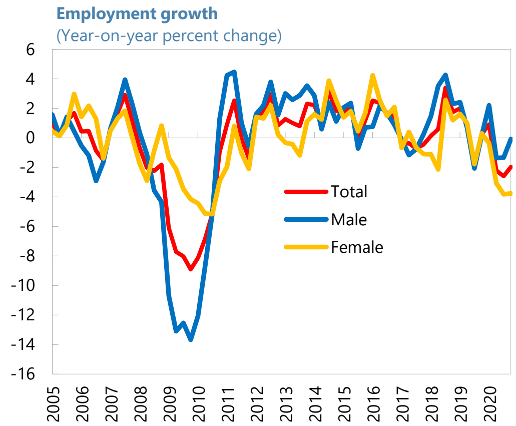
Sources: Bloomberg Finance L.P.; ECDC; Our World in Data, Worldometers; Google; IMF, WEO; and IMF staff calculations.

Figure 3. Lithuania: Labor Market Developments

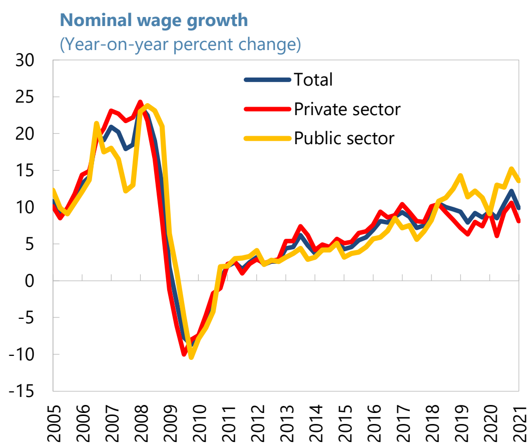
The rise in unemployment was milder than the GFC.



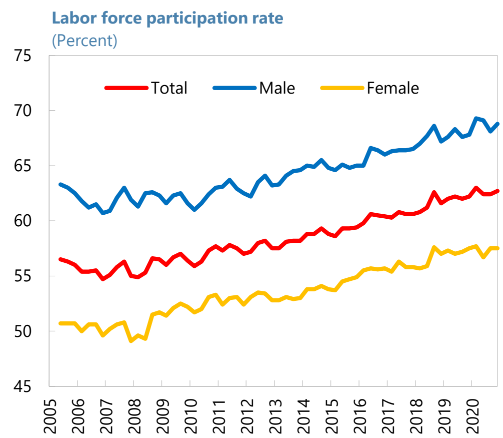
Employment shrank faster for women than men.



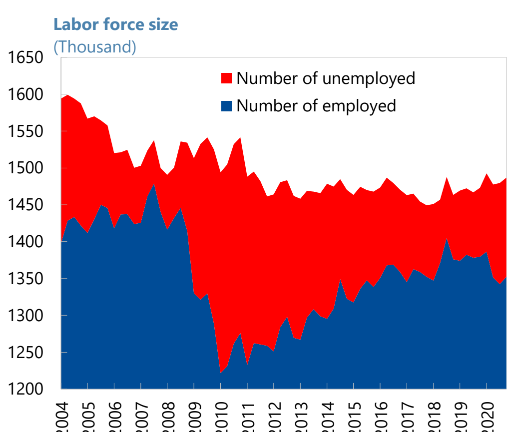
Public and private wage growth accelerated…



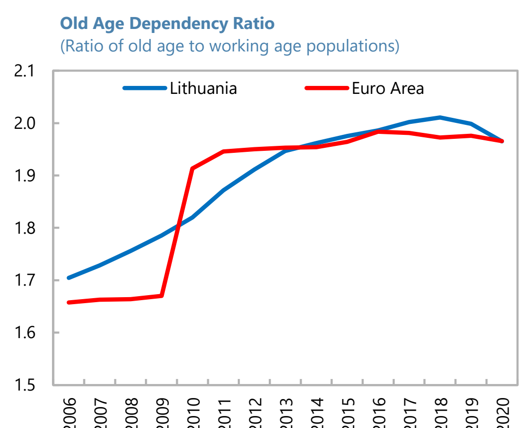
…and labor force participation rates were little affected…



…as newly registered unemployed entered the labor force in 2020.



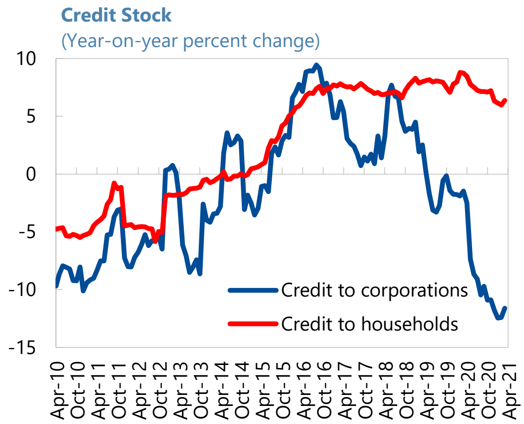
The rise in old-age dependency somewhat slowed.



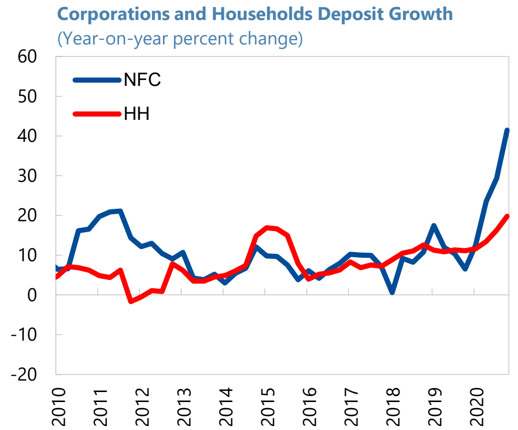
Sources: Haver; Eurostat; Lithuania Statistical Office; and IMF staff calculations.

Figure 4. Lithuania: Banking Sector Developments

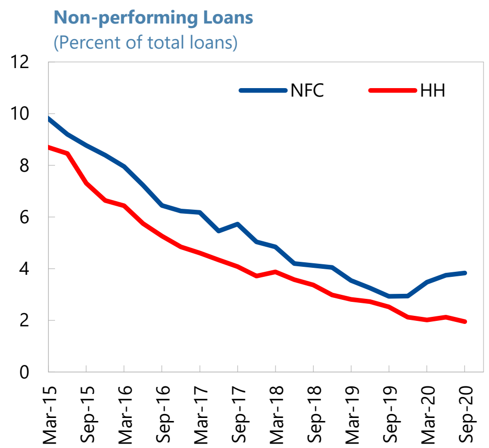
Credit to corporates has contracted significantly…



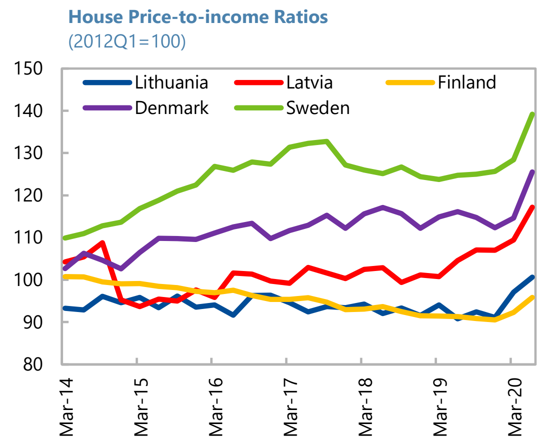
… while household and corporate deposits surged.



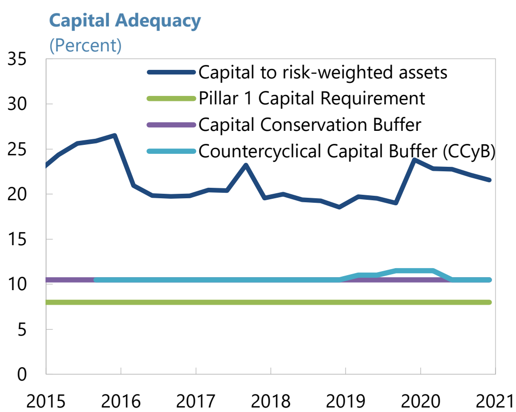
The levels of non-performing loans are manageable.



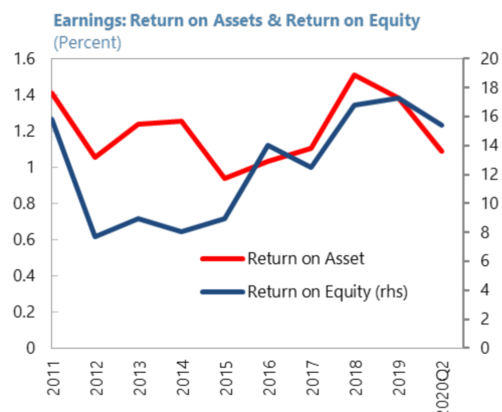
House prices are increasing but in line with income.



Banking sector capital is adequate.



Banking profitability has declined due to the pandemic, but it remains at a healthy level.

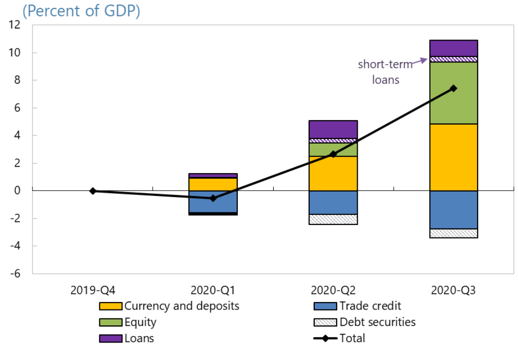


Sources: Bank of Lithuania; BIS; Haver Analytics; and IMF staff calculations.

Figure 5. Lithuania: Non-Financial Corporate and Household Financial Balance Sheets

NFCs built up cash and equity buffers in 2020…

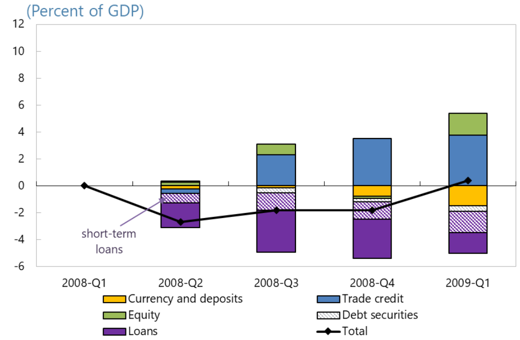
NFCs: Net Financial Transactions by Instrument, cumulative change since 2019Q4: *Pandemic*
(Percent of GDP)



Source: ECB and IMF staff calculations

…in stark contrast to borrowing during the GFC.

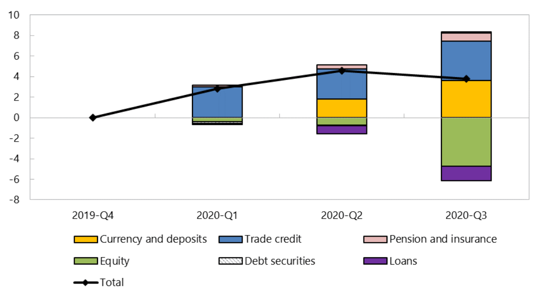
NFCs: Net Financial Transactions by Instrument, cumulative change since 2008Q1: *GFC*
(Percent of GDP)



Source: ECB and IMF staff calculations

Households also built up cash and deposits…

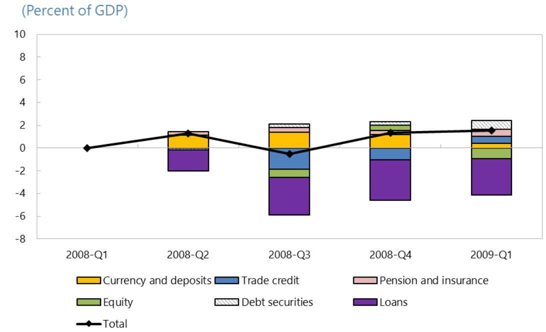
Households: Net Financial Transactions by Instrument, cumulative change since 2019Q4: *Pandemic*
(Percent of GDP)



Source: ECB and IMF staff calculations

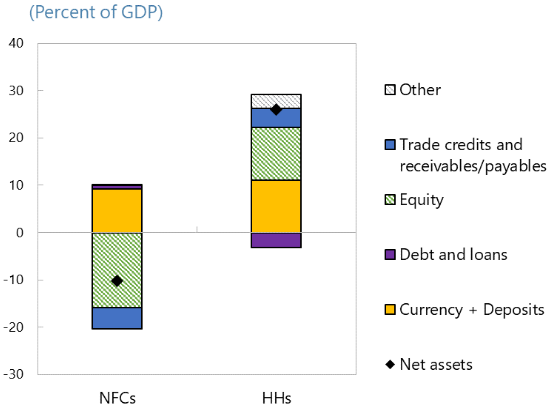
… also in contrast to borrowing during the GFC.

Households: Net Financial Transactions by Instrument, cumulative change since 2008Q1: *GFC*
(Percent of GDP)



Overall, changes in net financial wealth were driven by deposits and equity …

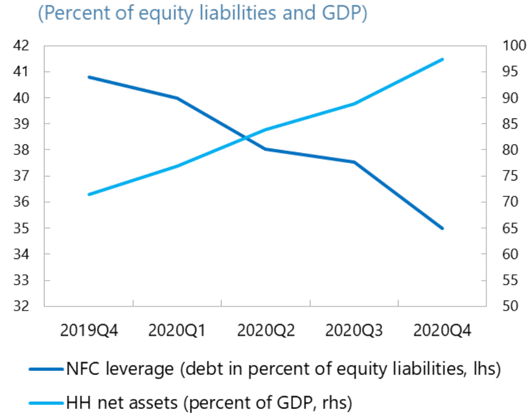
Change in Net Assets: 2019Q4-2020Q4
(Percent of GDP)



Source: Bank of Lithuania and IMF staff calculations. Changes in stocks include flows and valuation changes.

…which drove up household net worth and reduced NFC leverage throughout 2020.

NFC Leverage and HH Net Assets
(Percent of equity liabilities and GDP)



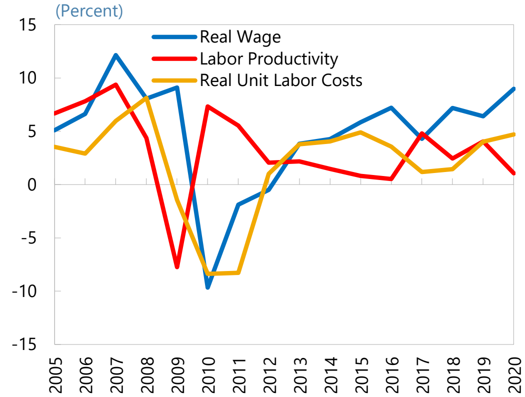
Source: Bank of Lithuania and IMF staff calculations

Sources: Bank of Lithuania; ECB; and IMF staff calculations.

Figure 6. Lithuania: Competitiveness Developments

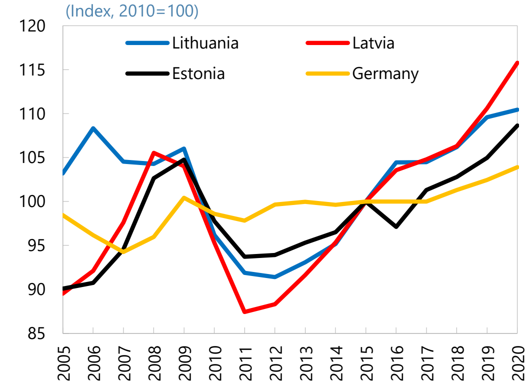
Wages have been growing faster than productivity…

Wage, Productivity and Unit Labor Cost Growth
(Percent)



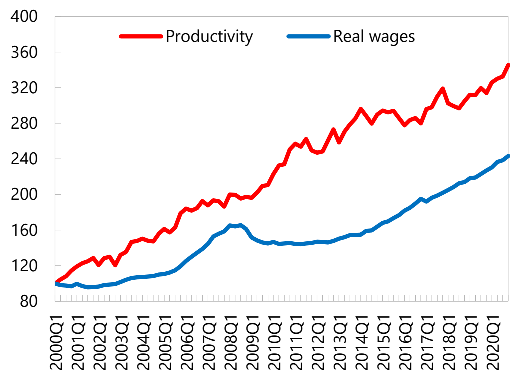
…with unit labor costs rising as well.

Real Unit Labor Costs
(Index, 2010=100)



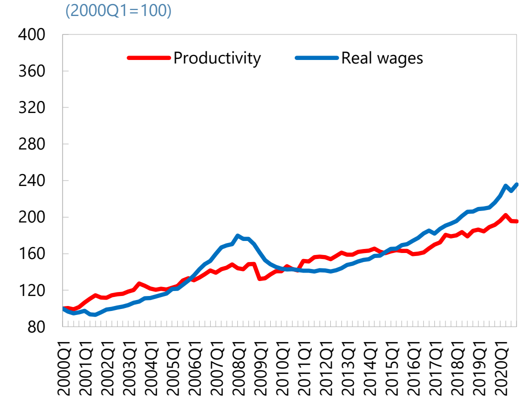
But manufacturing productivity remains above wages…

Productivity and Wages in Manufacturing
(2000Q1=100)



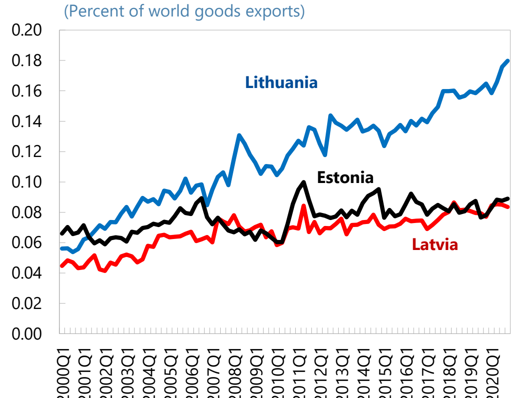
…and has supported wage growth in services….

Productivity and Wages in Services
(2000Q1=100)



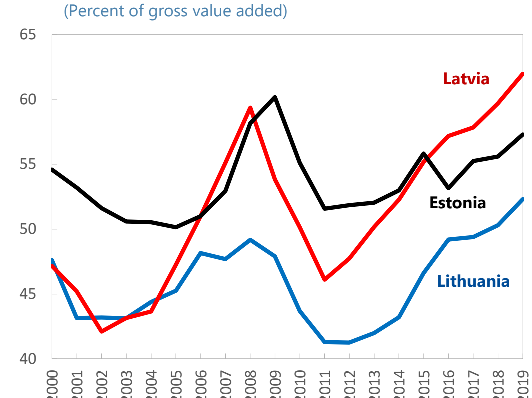
…and persistent increases in export shares.

World Export Shares
(Percent of world goods exports)



Wage shares have been rising but remain below peers.

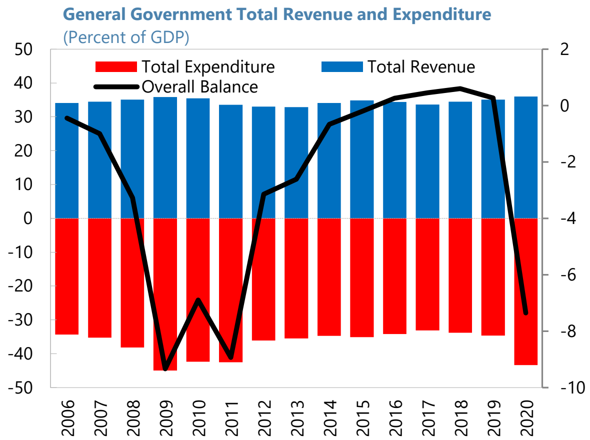
Wage Shares
(Percent of gross value added)



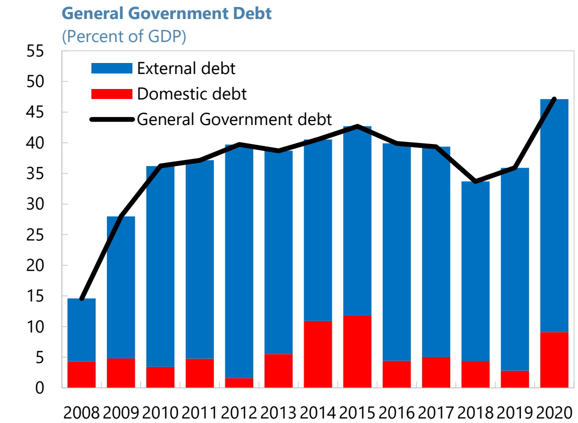
Sources: Statistics Lithuania, IMF Direction of Trade Statistics, Eurostat, IFS, and IMF staff calculations.

Figure 7. Lithuania: Fiscal Developments

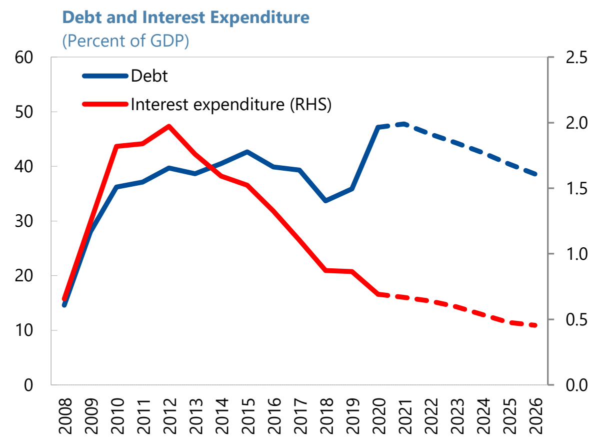
The fiscal balance deteriorated in response to the crisis…



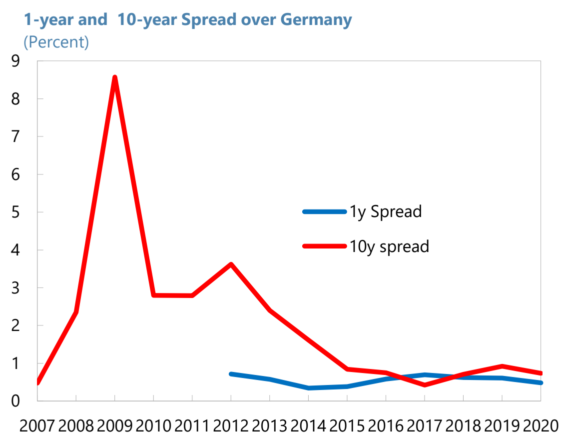
…and public debt rose above 45 percent for the first time…



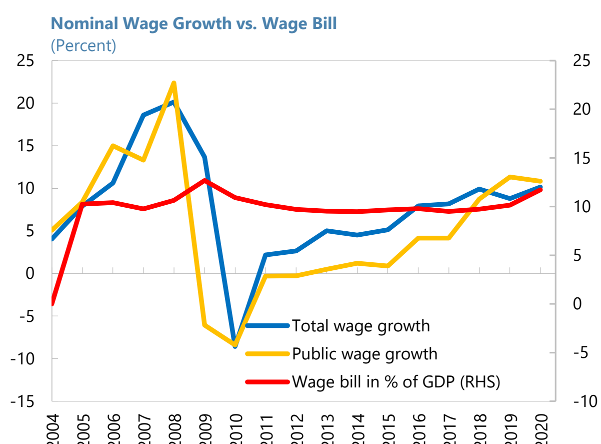
But is expected to decline with low interest expenses…



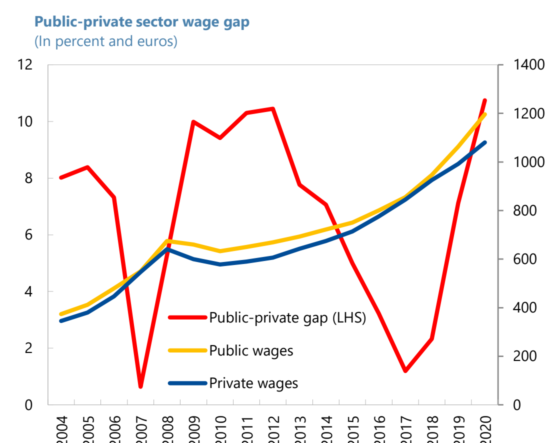
… and without an increase in borrowing costs.



Public wage growth has begun to increase the wage bill…



And public wages are now over 10 percent higher than private sector wages.



Sources: Ministry of Finance; Statistics Lithuania; Haver Analytics; and IMF staff calculations.

Table 1. Lithuania: Selected Economic Indicators, 2018–26

Life expectancy at birth (2019): 81 years (women), 71.5 years (men)

Quota (current, % of total): SDR 441.6 million , 0.09 percent
Main products and exports: refined fuel, machinery and equipment, chemicals, textiles, foodstuffs, plastics, wood products.
Key export markets: Russia, Latvia, Poland, Germany, U.S.

Per capita GDP (2020): € 17,510
Literacy rate (2015): 99.8%
At-risk-of-poverty (after transfers), share of population (2019): 20.6%

	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Projections					
Output									
Real GDP growth (annual percentage change)	3.9	4.3	-0.8	4.4	4.1	3.1	2.9	2.6	2.4
Domestic demand (contribution to growth)	3.3	1.8	-5.0	6.4	6.4	4.7	3.9	4.0	3.7
Private consumption growth (year-on-year, in percent)	3.7	3.4	-2.0	6.4	5.9	4.4	3.6	3.4	3.4
Domestic fixed investment growth (year-on-year, in percent)	10.0	6.2	-0.2	10.8	10.6	7.0	5.8	5.9	5.0
Inventories (contribution to growth)	-1.1	-1.6	-3.8	0.0	0.0	0.0	0.0	0.0	0.0
Net external demand (contribution to growth)	0.7	2.6	4.2	-2.1	-2.3	-1.6	-1.1	-1.3	-1.3
Export growth (year-on-year, in percent)	6.8	9.5	0.0	4.6	4.6	4.2	3.9	3.2	3.0
Import growth (year-on-year, in percent)	6.0	6.3	-5.3	7.9	8.0	6.4	5.3	4.8	4.5
Nominal GDP (in billions of euro)	45.5	48.8	48.9	52.4	56.0	59.2	62.3	65.3	68.2
Output gap (percent of potential GDP)	0.4	0.8	-0.9	0.3	0.9	0.6	0.4	0.2	0.0
Employment									
Employment (annual percentage change)	1.5	0.3	-1.5	1.7	0.2	0.0	-0.1	-0.2	-0.3
Unemployment rate (year average, in percent of labor force)	6.1	6.3	8.5	6.7	6.1	6.0	5.9	5.8	5.7
Average monthly gross earnings (annual percentage change) 1/	9.9	8.8	10.1	7.4	6.9	6.2	5.7	5.5	5.2
Average monthly gross earnings, real (annual percentage change)	7.2	6.4	9.0	4.0	4.0	3.5	3.2	3.2	3.0
Labor productivity (annual percentage change)	2.4	4.1	0.6	2.7	3.8	3.1	3.0	2.8	2.6
Prices									
HICP, period average (annual percentage change)	2.5	2.2	1.1	3.2	2.8	2.7	2.5	2.3	2.2
HICP core, period average (annual percentage change)	1.9	2.3	2.6	2.8	3.0	2.6	2.4	2.3	2.2
HICP, end of period (year-on-year percentage change)	1.8	2.7	-0.1	3.4	2.8	2.6	2.5	2.3	2.2
GDP deflator (year-on-year percentage change)	3.5	2.8	1.1	2.6	2.6	2.6	2.3	2.1	2.1
General government finances									
Revenue (percent of GDP)	34.5	35.1	36.0	36.7	37.0	36.6	35.7	36.0	35.5
Of which EU grants	0.8	1.0	0.8	1.4	1.6	1.2	0.6	0.9	0.7
Expenditure (percent of GDP)	33.8	34.6	43.4	42.2	39.9	38.2	36.8	36.5	36.0
Of which: Non-interest	33.0	33.8	42.7	41.6	39.3	37.6	36.2	36.0	35.5
Fiscal balance (percent of GDP)	0.6	0.5	-7.4	-5.5	-2.9	-1.5	-1.1	-0.5	-0.4
Fiscal balance excl. one-offs (percent of GDP)	0.6	0.4	-7.4	-5.5	-2.9	-1.5	-1.1	-0.5	-0.4
Structural fiscal balance (percent of potential GDP) 2/	0.7	0.6	-6.3	-5.0	-2.8	-1.4	-0.9	-0.4	-0.3
General government gross debt (percent of GDP)	33.7	35.9	47.1	47.7	45.9	44.3	42.5	40.5	38.6
Of which: Foreign currency-denominated	9.5	10.1	6.6	3.4	1.6	0.8	0.4	0.2	0.1
Balance of payments (in percent of GDP, unless otherwise specified)									
Current account balance	0.3	3.3	8.3	6.7	4.7	3.4	2.2	1.0	-0.3
Current account balance (billions of euros)	0.1	1.6	4.1	3.5	2.7	2.0	1.4	0.6	-0.2
Saving-investment balance (in percent of GDP)									
Gross national saving	20.6	20.8	20.4	20.1	19.4	18.9	18.6	18.1	17.4
Gross national investment	20.3	17.5	12.1	13.4	14.7	15.5	16.3	17.1	17.7
Foreign net savings	-0.3	-3.3	-8.3	-6.7	-4.7	-3.4	-2.2	-1.0	0.3

Sources: Lithuanian authorities; World Bank; Eurostat; and IMF staff estimates and projections.
Note: Data are presented on ESA2010, and BPM6 manuals basis.
1/ 2019 adjusted for tax reforms.
2/ Calculation takes into account standard cyclical adjustments as well as absorption gap.

Table 2. Lithuania: General Government Operations, 2018–26
(ESA 2010 aggregates, in percent of GDP)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Projections					
Statement of Operations									
Revenue	34.5	35.1	36.0	36.7	37.0	36.6	35.7	36.0	35.5
Revenue excluding EU grants	33.7	34.1	35.2	35.3	35.4	35.4	35.1	35.1	34.9
Tax revenue	17.1	20.4	20.5	20.7	20.8	20.8	20.6	20.7	20.6
Direct taxes	5.7	8.9	8.9	8.9	8.9	8.9	8.9	8.9	8.9
Personal income tax	4.0	7.1	7.2	7.2	7.2	7.2	7.2	7.2	7.2
Corporate income tax	1.5	1.6	1.5	1.6	1.6	1.6	1.6	1.6	1.6
Indirect taxes	11.5	11.5	11.7	11.8	11.9	11.8	11.8	11.8	11.7
VAT	7.7	7.9	7.9	8.1	8.2	8.1	8.1	8.0	8.0
Excises	3.2	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Other	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Social contributions	13.0	10.0	10.8	10.7	10.7	10.7	10.6	10.5	10.4
Grants	0.8	1.0	0.8	1.4	1.6	1.2	0.6	0.9	0.7
Other revenue	3.6	3.8	3.9	3.9	4.0	3.9	3.9	3.9	3.9
Total expenditure	33.8	34.6	43.4	42.2	39.9	38.2	36.8	36.5	36.0
Current spending	30.6	31.4	39.0	37.7	35.3	34.2	33.6	33.1	32.7
Compensation of employees	9.7	10.2	11.4	11.6	11.4	11.2	11.1	11.0	10.9
Goods and services	4.4	4.4	4.5	4.8	4.7	4.6	4.6	4.6	4.5
Interest payments	0.9	0.9	0.7	0.7	0.6	0.6	0.5	0.5	0.5
Foreign	0.8	0.6	0.2	0.5	0.5	0.4	0.4	0.3	0.3
Domestic	0.1	0.2	0.5	0.1	0.2	0.2	0.1	0.1	0.1
Subsidies	0.4	0.4	2.7	2.1	1.1	0.8	0.7	0.5	0.4
Grants	0.8	0.8	1.1	1.1	0.9	0.9	0.9	0.9	0.9
Social benefits	13.4	13.9	17.0	16.5	15.6	15.1	14.8	14.7	14.6
Other expense	0.9	0.9	0.9	1.0	1.0	0.9	0.9	0.9	0.9
Capital spending	3.2	3.2	4.4	4.6	4.6	4.0	3.2	3.3	3.2
Net lending (+) / borrowing (-)	0.6	0.5	-7.4	-5.5	-2.9	-1.5	-1.1	-0.5	-0.4
Net lending (+) / borrowing (-) excl. one-offs	0.6	0.4	-7.4	-5.5	-2.9	-1.5	-1.1	-0.5	-0.4
Net acquisition of financial assets	-2.1	5.5	3.8	-1.8	-1.7	-0.7	-0.6	-0.6	-0.6
Domestic	-1.6	3.5	5.3	-1.8	-1.7	-0.7	-0.6	-0.6	-0.6
Foreign	-0.4	2.0	-1.5	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	-2.7	5.1	11.2	3.7	1.2	0.9	0.4	-0.1	-0.2
Domestic	-0.1	-0.7	6.2	3.1	0.7	0.7	0.4	0.0	0.1
Foreign	-2.6	5.8	5.0	0.6	0.5	0.2	0.0	-0.1	-0.2
Financial Balance Sheet									
Financial assets	26.0	30.8	34.6	...	...	...	...	...	...
Currency and deposits	5.6	8.9	13.1	...	...	...	...	...	...
Securities other than shares	0.6	1.0	0.3	...	...	...	...	...	...
Loans	1.2	1.7	1.9	...	...	...	...	...	...
Shares and other equity	14.1	13.7	13.7	...	...	...	...	...	...
Other financial assets	4.4	5.5	5.7	...	...	...	...	...	...
Financial liabilities	40.7	44.4	56.0	...	...	...	...	...	...
Currency and deposits	0.4	0.4	0.2	...	...	...	...	...	...
Securities other than shares	31.4	34.8	42.8	...	...	...	...	...	...
Loans	5.0	5.1	8.2	...	...	...	...	...	...
Other liabilities	3.8	4.1	4.7	...	...	...	...	...	...
Net financial worth	-14.7	-13.6	-21.5	...	...	...	...	...	...
Memorandum items:									
GDP (in millions of euros)	45,491	48,809	48,930	52,405	55,964	59,193	62,279	65,268	68,186
General government debt (Maastricht def.)	33.7	35.9	47.1	47.7	45.9	44.3	42.5	40.5	38.6
Foreign debt	29.3	33.1	38.0	36.1	34.3	32.6	31.0	29.4	28.0
Domestic debt	4.4	2.8	9.1	11.6	11.6	11.7	11.5	11.0	10.6

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

Note: Passive projections from 2022 onward. Projections incorporate only announced budgetary measures.

Table 3. Lithuania: Balance of Payments, 2018–26
(Billions of Euros, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
						Projections			
Current account balance	0.1	1.6	4.1	3.5	2.7	2.0	1.4	0.6	-0.2
Merchandise trade balance	-2.8	-2.3	-0.3	-1.7	-2.6	-3.4	-4.1	-4.9	-5.8
Exports (f.o.b.)	24.6	26.0	25.5	28.0	29.4	30.9	32.4	34.0	35.6
Imports (f.o.b.)	27.3	28.3	25.8	29.8	32.1	34.2	36.5	38.9	41.3
Services balance	3.6	4.9	5.0	5.6	5.7	5.8	6.0	6.1	6.3
Exports	9.7	11.8	10.8	12.8	13.4	14.0	14.7	15.5	16.2
Imports	6.0	6.9	5.8	7.1	7.7	8.2	8.7	9.3	9.9
Primary income balance	-1.4	-1.7	-1.2	-1.1	-1.1	-1.2	-1.3	-1.4	-1.5
Receipts	1.1	1.1	1.2	1.3	1.4	1.4	1.5	1.6	1.7
Payments	2.6	2.8	2.4	2.4	2.5	2.6	2.8	3.0	3.2
Secondary income balance	0.7	0.8	0.5	0.7	0.7	0.7	0.8	0.8	0.8
Capital and financial account balance	0.8	-1.6	-3.3	0.8	0.5	1.3	1.2	2.0	2.2
Capital account balance	0.7	0.8	1.0	1.4	1.3	1.5	1.2	1.5	1.5
Foreign direct investment balance	-0.3	-0.9	-0.7	-0.7	-0.8	-0.8	-0.9	-1.0	-1.1
Portfolio investment balance	1.7	-2.4	-1.9	-0.4	0.2	0.4	0.7	0.6	0.6
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment balance	-1.5	5.8	6.8	1.7	1.4	0.6	0.2	0.0	-0.2
Errors and omissions	0.2	-0.7	-1.2	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	1.2	-0.7	-0.4	4.3	3.1	3.3	2.6	2.6	2.0
Financing	-1.1	0.6	0.4	-4.3	-3.1	-3.3	-2.6	-2.6	-2.0
Gross international reserves (increase: -)	…	…	…	…	…	…	…	…	…
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	0.3	3.3	8.3	6.7	4.7	3.4	2.2	1.0	-0.3
Trade balance of goods and services	1.9	5.2	9.7	7.5	5.5	4.1	3.0	1.9	0.8
Exports	75.2	77.4	74.1	77.9	76.5	75.9	75.6	75.7	75.9
Imports	73.4	72.2	64.4	70.4	71.1	71.7	72.6	73.8	75.2
Primary income	-3.1	-3.5	-2.4	-2.1	-2.0	-2.0	-2.1	-2.2	-2.3
Secondary income	1.6	1.6	1.1	1.3	1.3	1.3	1.3	1.3	1.2
Capital and financial account balance	1.8	-3.4	-6.7	1.5	0.9	2.1	1.9	3.0	3.2
Capital account balance	1.6	1.7	2.0	2.8	2.3	2.5	1.9	2.3	2.2
Foreign direct investment balance	-0.6	-1.9	-1.4	-1.3	-1.4	-1.4	-1.5	-1.6	-1.7
Portfolio investment balance	3.7	-4.9	-3.8	-0.7	0.4	0.7	1.1	0.9	0.9
Financial derivatives balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment balance	-3.3	11.8	13.9	3.2	2.4	1.1	0.3	-0.1	-0.4
Overall balance	2.5	-1.4	-0.8	8.2	5.6	5.5	4.1	4.0	3.0
Gross external debt 1/	78.1	66.4	66.9	62.1	57.6	54.1	50.9	47.9	45.2
Public	49.9	42.0	42.5	39.5	37.1	34.8	32.7	30.6	28.7
Short-term	22.5	11.0	10.7	9.6	8.6	7.7	6.9	6.2	5.5
Long-term	27.5	30.9	31.8	29.9	28.5	27.1	25.7	24.4	23.2
Private	28.2	24.4	24.4	22.6	20.5	19.3	18.2	17.3	16.5
Short-term	17.9	14.0	12.4	14.4	16.0	18.2	20.4	22.6	24.7
Long-term	10.3	10.4	12.1	8.1	4.5	1.1	-2.2	-5.2	-8.2
Gross external debt (in percent of GS exports)	103.8	85.7	90.3	79.8	75.3	71.3	67.3	63.3	59.5
Net external debt	14.2	9.3	-1.9	-15.7	-24.4	-31.4	-36.3	-40.3	-42.9
Net international investment position	-30.4	-24.1	-15.3	-4.0	4.1	10.5	14.8	18.2	20.1
Merchandise export volume (percent change) 2/	6.8	9.5	0.0	4.6	4.6	4.2	3.9	3.2	3.0
Merchandise import volume (percent change) 2/	6.0	6.3	-5.3	7.9	8.0	6.4	5.3	4.8	4.5
Merchandise export prices (percent change) 2/	3.0	0.9	-4.1	7.6	0.3	0.6	0.9	1.6	1.7
Merchandise import prices (percent change) 2/	4.5	-0.7	-5.6	8.5	-0.2	0.4	1.2	1.6	1.8
GDP (in billion of Euros)	45.5	48.8	48.9	52.4	56.0	59.2	62.3	65.3	68.2

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/ Derived from national accounts data.

Table 4. Lithuania: Summary of Monetary Accounts, 2012–20
(Billions of Euros, unless otherwise specified)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Monetary Authority									
Gross foreign assets	6.4	6.0	7.9	2.9	3.0	4.2	5.7	5.1	4.7
Gross foreign liabilities	0.0	0.0	0.1	0.2	0.2	0.2	0.3	0.3	0.4
Net foreign assets	6.4	6.0	7.8	2.7	2.8	4.0	5.3	4.7	4.4
Net domestic assets	-1.7	-1.0	-1.9	6.5	9.8	11.7	13.4	15.4	15.7
Net credit to government	-1.1	-0.5	-1.2	0.0	1.0	-0.1	1.2	1.2	1.2
Credit to banks	0.0	0.0	0.0	1.0	0.7	0.6	0.5	2.4	2.7
Credit to private sector	0.0	0.0	0.0	1.7	4.8	8.0	8.9	8.9	8.9
Other items, net	-0.7	-0.6	-0.7	3.8	3.3	3.3	2.9	2.9	2.9
Reserve money	4.7	4.9	5.9	9.1	12.6	15.7	18.8	20.1	20.1
Currency outside the central bank	3.3	3.4	1.7	6.1	6.2	6.4	6.8	6.8	6.8
Currency outside banks	3.0	3.2	1.4	5.7	5.8	6.0	6.3	6.8	6.8
Cash in vaults of banks	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.0	0.0
Deposit money banks' deposits with BoL	1.4	1.5	4.3	3.1	6.4	9.3	12.0	13.4	13.4
Banking Survey									
Net foreign assets	2.8	2.9	4.5	-2.3	-3.5	-2.7	-2.2	-3.4	-7.1
Monetary authority	6.4	6.0	7.8	2.7	2.8	4.0	5.3	4.7	4.4
Banks and other banking institutions	-3.6	-3.1	-3.3	-5.0	-6.2	-6.7	-7.5	-8.2	-11.5
Net domestic assets	12.9	13.5	12.1	24.3	27.1	27.7	30.0	33.3	36.9
Net claims on government 1/	0.3	1.7	0.5	1.7	2.3	0.7	1.9	4.5	-25.5
Monetary authority	-1.1	-0.5	-1.2	0.0	1.0	-0.1	1.2	1.2	1.2
Banks and other banking institutions	1.4	2.1	1.7	1.8	1.3	0.8	0.8	3.3	-26.7
Credit to private sector	15.3	14.9	14.8	17.1	21.3	25.2	27.2	27.7	61.4
Credit to nonbank financial institutions	1.3	0.9	0.9	3.1	6.5	9.9	11.2	11.4	11.4
Other items, net	-4.0	-4.0	-4.1	2.5	-3.1	-8.1	-10.3	-10.3	-10.3
Broad money	15.7	16.4	16.6	22.0	23.6	25.0	27.8	30.7	29.6
Currency outside banks	3.0	3.2	1.4	5.7	5.8	6.0	6.3	6.8	6.8
Deposits	12.7	13.2	15.2	16.3	17.8	19.0	21.5	23.1	23.1
In national currency	9.3	9.7	11.3	15.4	16.9	18.1	20.6	22.1	22.1
In foreign currency	3.4	3.5	4.0	0.9	0.9	0.9	0.9	0.9	0.9
Memorandum items:									
Reserve money (yearly percent change)	-6.4	4.9	20.9	53.3	38.4	24.9	19.3	7.1	0.0
Broad money (yearly percent change)	7.2	4.4	1.2	32.9	7.2	5.8	11.4	7.3	0.0
Private sector credit (yearly percent change)	-0.8	-2.3	-0.9	4.1	7.1	4.5	6.0	2.7	179.9
Money multiplier	3.3	3.3	2.8	2.4	1.9	1.6	1.5	1.5	1.5
Currency outside banks, in percent of deposits	23.6	24.0	8.9	34.9	32.5	31.6	29.3	29.3	29.3
Foreign-currency deposits (percent of total deposi	26.4	26.5	26.0	5.5	5.1	4.8	4.1	4.1	4.1
Foreign-currency loans (percent of total loans) 2/	72.7	72.1	72.7	0.9	0.6	0.5	0.4	0.4	0.4
Velocity of broad money	2.1	2.1	2.2	1.7	1.6	1.7	1.6	1.6	1.6
Gross official reserves (billions of U.S. dollars) 3/	8.4	8.0	8.8	1.9	3.0	4.6	4.9	5.6	8.5
Gross official reserves (billions of euros) 3/	6.4	6.0	7.9	2.9	3.0	4.2	5.7	5.1	4.7
GDP	33.4	35.0	36.6	37.3	38.9	42.3	45.5	48.8	48.9

Sources: Bank of Lithuania; and IMF staff estimates and projections.

1/ Excludes local government deposits; includes counterpart funds.

2/ Loans to households and non-financial corporations.

3/ BOP basis. Differs from gross foreign assets as shown in the monetary authority's balance sheet because of valuation effects (BoP-basis official reserves include accrued interest on deposits and securities but exclude investments in shares and other equity).

Table 5. Lithuania: Financial Soundness Indicators, Banking System Data, 2012–20

(In percent, unless otherwise indicated)

	Dec-12	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18	Dec-19	Jun-20
Capital adequacy									
Regulatory capital to risk-weighted assets 1/ 2/	15.7	17.6	21.3	24.9	19.4	19.1	18.6	23.7	23.1
Regulatory Tier 1 capital to risk-weighted assets 1/ 2/	14.6	17.1	20.9	24.3	19.1	18.8	18.5	23.3	22.7
Capital to assets 1/	12.3	12.6	12.9	11.1	10.4	9.4	9.6	6.9	6.8
Asset quality									
Nonperforming loans to capital 1/ 3/	53.4	42.6	46.9	38.3	35.5	28.6	23.1	15.1	14.6
Nonperforming loans net of provisions to capital 1/ 3/	20.8	19.7	29.8	25.0	23.2	18.8	15.4	5.4	3.2
Nonperforming loans to total (non-interbank) loans 1/ 3/	14.8	11.6	7.0	5.7	4.1	3.1	2.5	1.5	1.4
	..	..	..	..	..	..			
Nonperforming loans to capital 1/ 3/ 4/	53.4	42.6	46.9	38.3	35.5	28.6	23.1	15.1	14.6
o/w impaired loans to capital 1/ 3/ 4/	39.7	27.4	29.1	23.4	23.1	18.4	22.3	14.2	13.1
o/w non-impaired loans overdue more than 60 days to capital 1/ 3/ 4/	13.7	15.2	8.0	6.4	7.9	5.8	..	..	..
Nonperforming loans net of provisions to capital 1/ 3/ 4/ 5/	20.8	19.7	29.8	25.0	23.2	22.9	15.4	5.4	3.2
Nonperforming loans to total (non-interbank) loans 3/ 4/	13.6	11.0	7.0	5.7	4.1	4.1	2.5	1.5	1.4
o/w impaired loans to total (non-interbank) loans 4/	11.4	8.5	4.7	3.8	3.1	2.2	2.4	1.4	1.3
o/w non-impaired loans overdue more than 60 days to total (non-interbank) loans 4/	2.2	2.5	1.2	1.0	0.9	0.6	..	..	..
Impairment losses to total (non-interbank) loans 6/ 7/	5.6	4.2	2.5	2.0	1.4	1.1	0.8	0.6	0.7
Impairment losses to nonperforming loans 3/ 4/ 6/ 7/	61.0	53.7	36.5	34.7	34.7	30.8	33.4	39.4	45.4
Sectoral distribution of corporate loans 8/									
Agriculture, forestry and fishing	2.3	2.8	2.9	3.6	3.7	3.6	3.6	3.2	3.3
Mining and quarrying	0.6	0.5	0.5	0.5	0.5	0.5	0.4	0.3	0.3
Manufacturing	18.3	17.9	15.7	14.7	14.2	14.3	14.0	14.9	14.7
Electricity, gas, steam and air conditioning supply	6.8	7.6	9.5	11.0	8.7	4.7	5.3	7.4	5.5
Water supply; sewerage, waste management and remediation activities	0.7	0.8	1.0	1.0	0.9	0.8	0.6	0.6	0.6
Construction	10.4	8.6	7.3	6.1	5.4	5.2	3.7	3.1	3.4
Wholesale and retail trade; repair of motor vehicles and motorcycles	19.7	19.3	20.3	21.9	21.3	22.7	25.4	23.0	20.0
Transportation and storage	4.0	5.7	5.0	5.8	5.8	6.1	8.7	9.3	8.9
Accommodation and food service activities	2.8	2.7	2.6	2.4	2.4	2.4	3.0	2.6	2.9
Information and communication	0.8	0.8	0.9	0.8	2.4	2.4	2.0	1.8	1.9
Real estate activities	27.8	28.3	27.8	26.3	26.6	25.8	25.0	27.0	30.1
Professional, scientific and technical activities	4.0	2.6	3.7	2.6	3.2	5.0	2.6	1.8	2.4
Administrative and support service activities	0.9	1.0	1.8	2.0	3.0	4.4	2.6	2.4	3.0
Remaining activities	1.1	1.2	1.1	1.3	1.8	2.2	3.0	2.6	2.9
Residential real estate loans to total (non-interbank) loans	37.9	38.0	28.7	29.8	31.3	31.3	31.1	30.1	29.1
Large exposures to regulatory capital 1/ 5/	0.0	0.0	0.0	0.0	0.0	0.0	..	..	..
Earnings and profitability									
RoE 1/ 9/	7.7	8.9	8.1	9.0	14.0	12.5	16.8	17.3	14.1
RoA 9/	1.1	1.2	1.3	0.9	1.0	1.1	1.5	1.4	1.0
Interest margin to gross income	41.1	24.3	57.5	62.1	61.0	62.8	54.7	54.3	58.7
Noninterest expenses to gross income	63.1	60.5	58.6	57.4	52.0	55.0	51.0	53.8	54.9
Trading and foreign exchange gains (losses) to gross income	9.9	9.9	9.4	7.9	11.4	5.9	7.5	8.1	7.7
Personnel expenses to noninterest expenses	38.2	38.3	37.4	41.2	42.6	41.1	42.1	38.7	39.0
Liquidity									
Liquidity coverage ratio	..	..	..	..	266.3	281.9	254.2	272.4	399.6
Liquidity ratio (liquid assets to current liabilities) 10/	41.2	41.2	43.6	..	..	..	..	..	..
Liquid assets to total assets 10/	23.9	24.0	29.3	..	15.3	23.6	25.5	22.7	23.4
Current liabilities to total liabilities 10/	67.7	73.1	81.6	..	..	..	..	..	..
3-month VILIBOR-EURIBOR spread, b.p. 8/	49.0	12.0	10.0	..	..	..	..	..	..
Spread between highest and lowest interbank rate, b.p. 10/	34.0	39.0	25.0	..	..	..	..	..	..
Loan to deposit ratio in the banking sector 11/	127.9	121.5	101.6	98.6	99.0	94.6	89.3	81.9	73.1
Foreign exchange risk									
Foreign-currency-denominated loans to total (non-interbank) loans 12/	71.6	68.7	..	..	..	..	..	..	..
Foreign-currency-denominated liabilities to total liabilities 12/	50.4	48.2	..	..	..	..	..	..	..
Net open position in foreign exchange to regulatory capital 1/ 13/	0.3	0.4	0.4	0.1	0.0	0.0	0.0	0.0	0.0
Memo item									
Provisioning (in percent of NPLs)	21.3	16.5	..	..	..	..	..	..	..

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

Notes: Banking system data was compiled by aggregating banks solo (i.e. no cross-border cross-sector consolidation) data. No intra-sector adjustments were made. FSIs were mostly derived from supervisory data and comprise all banks and foreign bank branches incorporated in Lithuania, except if stated otherwise. Starting 2008, bank financial data is collected through FINREP tables (EU-wide common reporting templates). This might have some influence on the values of the indicors compiled. The fact should be considered when making straightforward comparison of time series.

1/ Excluding foreign bank branches.
2/ 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. Implementation of Past IMF Recommendations

2019 Article IV Recommendations	Policy Actions
Fiscal Policy	
Budget slippages. With a procyclical stance and increasing budget rigidities and spending pressures, it is important to prevent budget slippages. Closely monitor fiscal risks in a transparent and comprehensive framework that analyzes economic impacts and interactions.	In November 2020, the Ministry of Finance published its first Fiscal Risks Report, in line with IMF technical assistance recommendations.
Financial Sector Policy	
AML/CFT. Complement recommendations from the 2018 MONEYVAL report and inter-agency coordination with adequate resources for all agencies involved.	The authorities approved the establishment of the Centre of Excellence in Anti-Money Laundering in collaboration with private sector.
Structural Reforms	
Education. Address overcapacities (reduce number of teachers and consolidate school and university infrastructure). Review nexus between universities, financial incentives and quality standards. Planned wage increases should be made conditional on progress in network optimization.	Since approved reforms in 2018 in line with past recommendations, implementation has not meaningfully progressed yet planned wage increases have continued. COVID-19 has delayed reforms, but the government is preparing its plan to resume implementation efforts.
Health. Continue reorganizing and rationalizing hospital sector, improve out-patient and long-term care, and expand role of primary care. Develop a copayments system to incentivize cost efficiency. Strengthen accountability, particularly at municipal level. Planned wage increases should be made conditional on progress in network optimization.	The authorities have diverted more financial resources, including wage increases, to the health sector in response to COVID-19. Consultations with the European Commission on best practices in inter-hospital communication and coordination occurred in 2020. The government is preparing its plan to renew implementation efforts, including by introducing legal changes to allow for joint ownership of hospitals with municipalities.
Tax policy. Reduce social security contributions for low wage earners. Rebalance tax system from labor taxes towards wealth and capital (e.g. environmental and property). Continue tax administration reform. Reduce tax exemptions and privileged regimes.	Tax reform in 2019 slightly reduced labor tax wedge by raising PIT rates, lowering social contributions and increasing the non-taxable income threshold. The flat PIT was replaced by two brackets. The government is undergoing an evaluation of the tax system with specific proposals expected in the Fall.

2019 Article IV Recommendations	Policy Actions
Structural Reforms (concluded)	
Social assistance. Given limited resources, social protection should increase reliance on means-tested programs. Design should avoid welfare dependency and disincentives to work (e.g. in-work benefits)	In response to COVID-19, large temporary increases in social assistance were provided in 2020 and into 2021, including both targeted and universal measures.
Labor market. Reduce reliance on employment subsidies and focus on most disadvantaged groups only. Shift emphasis to well-designed training curricula to upskill workforce. Strengthen ALMPs, including life-long learning and apprenticeships, and increase its funding.	In response to COVID-19, large temporary wage subsidies were provided to firms to support employment and incomes. The government plans to resume focus on pre-existing issues including skills gaps and ALMPs.
Pensions. Link retirement age to life expectancy and tighten early retirement. Raise gross pensions (to at least preserve replacement ratios) Scale back incidence of disability pensions	One-off increases in pension benefits outside of the indexation formula were introduced. In response to COVID-19, temporary deferrals of social security contributions were introduced but did not affect the systems fiscal sustainability.
Innovation. Consolidate a highly fragmented system and improve coordination	The government plans to advance its promotion of innovation in its new program.
Source: IMF staff	

Annex II. External Sector Assessment

Overall Assessment: *The external position of Lithuania in 2020 was substantially stronger than the level implied by fundamentals and desirable policies. Over the medium term and under the policies expected under the baseline scenario, Lithuania's current account balance is expected to decline towards the norm as investment returns to pre-pandemic levels, private sector savings decline, and global fiscal policies normalize. Therefore, there is no concern about long-term misalignments.*
Potential Policy Responses: *The envisaged increase in public investment should support a return to pre-pandemic domestic investment and a reduction in the fiscal policy gap relative to other countries.*

Foreign Assets and Liabilities: Position and Trajectory

Background. Since 2015, the NIIP has strengthened by about 28 percent of GDP. It reached -15.6 of GDP in 2020 from -24.1 percent in 2019. In 2020, gross assets increased to 98.7 percent of GPD, while liabilities reached 114.3 percent of GDP. The increase in assets outpaced the increase in liabilities by almost two to one. While gross external debt increased by about 6.5 percent of GDP, net debt declined by 11.1 percent of GDP to -1.9 percent of GDP, as deposits increased by almost 15 percent of GDP.

Assessment. The current NIIP and its projected path does not imply risks to external sustainability.[1]

2020 (% GDP)	NIIP: -15.6	Gross Assets: 98.7	Debt Assets: 8.8	Gross Liab.: 114.3	Debt Liab.: 74.2

Current Account

Background. The 2020 current account surplus reached 8.4 percent of GDP. This figure is quite large as the current account has been broadly balanced over the last five years. It is also a significant increase from 3.3 percent of GDP in 2019. Part of this is explain by the oil-related balance, which deteriorated some 2.8 percent of GDP. Net tourism declined by over 40 percent, but given its relatively small size, it accounted for only 0.1 percent of GDP. While national savings remain broadly unchanged in 2020, investment decline by 4.6 percent of GDP. At 12.8 percent of GDP in 2020, the level of gross capital formation was similar to the one experienced during the global financial crisis, and well below the 19.5 percent of GDP average during the last five years.

Assessment. The EBA-lite CA model estimates that the current account gap is 6.8 percent of GDP. The cyclically adjusted CA was 8.6 percent in 2020, with Lithuania relatively strong cyclical position more than compensating the impact of the pandemic on oil and tourism. In contrast, the norm envisages a surplus of only 1.8 percent of GDP. Policies account for about 4.3 percent of GDP. The main contributors are fiscal policy—which despite being quite supportive, remains modest relative to other countries—and health spending which is relatively low.

Lithuania: Model Estimates for 2020 (in percent of GDP)

	CA model	REER model
CA-Actual	**8.4**	
Cyclical contributions (from model) (-)	-0.3	
COVID-19 adjustor (+) 1/	-1.1	
Natural disasters and conflicts (-)	-0.1	
Adjusted CA	**7.7**	
CA Norm (from model) 2/	**1.8**	
Adjustments to the norm (+)	0.0	
Adjusted CA Norm	**1.8**	
CA Gap	**5.9**	**6.1**
o/w Relative policy gap	4.3	
Elasticity	-0.52	
REER Gap (in percent)	**-11.4**	**-11.7**

1/ Additional cyclical adjustment to account for the temporary impact of the pandemic on oil trade balances (-1.19 percent of GDP) and on tourism (0.06 percent of GDP).

2/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate

Background. The exchange rate appreciated about 2 percent in 2020, and about 4 percent during the last five years. As of May, the exchange rate has appreciated by 2.3 percent relative to the 2020 average level.

Assessment. The REER model estimates a REER gap of -11.7 percent, which is consistent with a CA gap of 6.1 percent—with the estimate being broadly in line with those obtain from the CA model—albeit in this model the relative policy gap is insignificant.

Capital and Financial Accounts: Flows and Policy Measures

Background. Lithuania experienced strong capital flows during 2020. Outflows amounted to 16.3 percent of GDP, while inflows reached 7.9 percent of GDP. The outflow largely reflects the acquisition of currency and deposits assets (14.7 percent of GDP), mainly by the Bank of Lithuania. Direct and portfolio flows continued to show net inflows, albeit slightly more modest.

	Financial Assets		Financial Liabilities		Net outflows	
	2019	2020	2019	2020	2019	2020
Net acquisition	**-0.7**	**16.3**	**-4.6**	**8.4**	**3.8**	**7.9**
Direct	1.0	1.4	2.9	2.7	-1.9	-1.4
Portfolio	-1.4	-0.9	3.5	3.0	-4.9	-3.8
Derivatives	-0.4	-0.4	-0.4	-0.3	0.0	0.0
Other	0.9	16.7	-10.9	2.7	11.8	14.0
o.w. currency and deposits	-0.8	14.7	-11.8	-0.8	11.0	15.5
o.w. Bank of Lithuania	-0.8	11.7	-10.3	-0.5	9.5	12.2
Reserves	-1.2	-0.8			-1.2	-0.8

Assessment. While gross debt remains high, most of it is hold by the public sector, risks are ameliorated by the holding of significant assets, with the increased holdings of currency and deposits assets by the central bank.

FX Intervention and Reserves Level

Background. The euro has the status of a global reserve currency.

Assessment. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.

Annex III. Public Sector Debt and External Sustainability Analysis

Table 1. Lithuania: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

In percent GDP, unless otherwise indicated

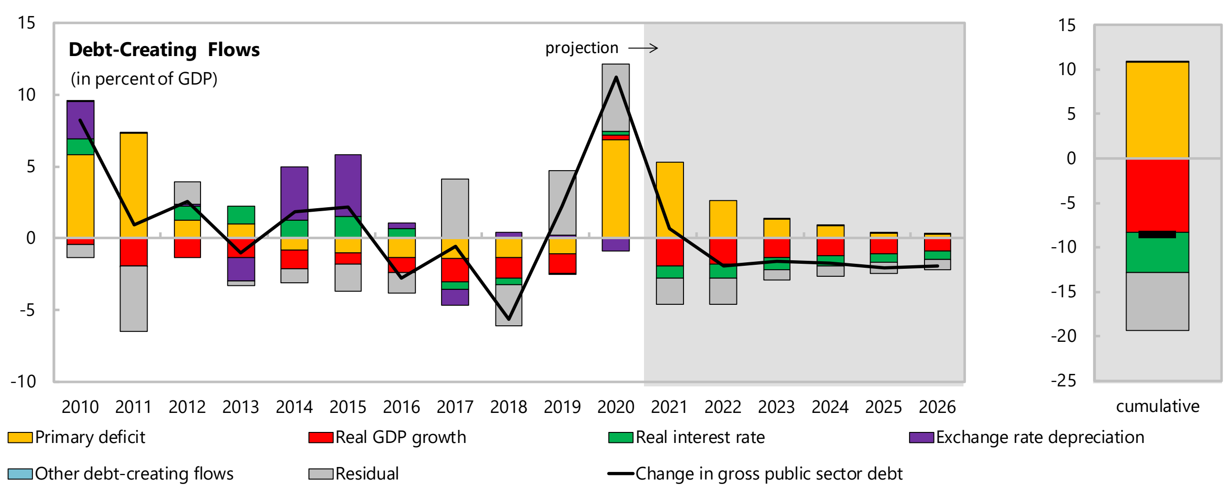
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2010-2018 [2/]	2019	2020	2021	2022	2023	2024	2025	2026
Nominal gross public debt	38.6	35.9	47.1	47.8	45.9	44.3	42.5	40.5	38.6
Public gross financing needs	7.3	5.8	12.6	9.9	7.1	5.3	4.3	4.5	3.4
Real GDP growth (in percent)	3.5	4.3	-0.9	4.4	4.1	3.1	2.9	2.6	2.4
Inflation (GDP deflator, in percent)	2.5	2.8	1.1	2.6	2.7	2.6	2.2	2.1	2.1
Nominal GDP growth (in percent)	6.0	7.3	0.2	7.1	6.9	5.8	5.1	4.8	4.5
Effective interest rate (in percent) [4/]	4.4	2.8	1.9	0.8	0.7	0.7	0.6	0.6	0.7

As of June 14, 2021		
Sovereign Spreads		
EMBIG (bp) 3/		49
5Y CDS (bp)		59
Ratings	Foreign	Local
Moody's	A2	A2
S&Ps	A+	A+
Fitch	A	A

Contribution to Changes in Public Debt

	Actual			Projections							
	2010-2018	2019	2020	2021	2022	2023	2024	2025	2026	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.6	2.2	11.2	0.7	-2.0	-1.6	-1.8	-2.1	-1.9	-8.6	
Identified debt-creating flows	1.4	-2.3	6.6	2.5	-0.1	-0.9	-1.0	-1.3	-1.1	-2.0	
Primary deficit	1.0	-1.1	6.9	5.3	2.6	1.3	0.9	0.4	0.3	10.8	-1.4
Automatic debt dynamics [5/]	0.4	-1.2	-0.3	-2.8	-2.7	-2.2	-1.9	-1.7	-1.4	-12.8	
Interest rate/growth differential [6/]	-0.6	-1.4	0.6	-2.8	-2.7	-2.2	-1.9	-1.7	-1.4	-12.8	
Of which: real interest rate	0.6	-0.1	0.3	-0.8	-0.9	-0.9	-0.7	-0.6	-0.5	-4.5	
Of which: real GDP growth	-1.2	-1.4	0.3	-1.9	-1.8	-1.4	-1.2	-1.1	-0.9	-8.3	
Exchange rate depreciation [7/]	1.0	0.2	-0.9	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization/Drawdown of deposits	0.0	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	
Residual, including asset changes [8/]	-0.8	4.5	4.7	-1.8	-1.9	-0.7	-0.7	-0.7	-0.8	-6.6	



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 - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) 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 - π (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.

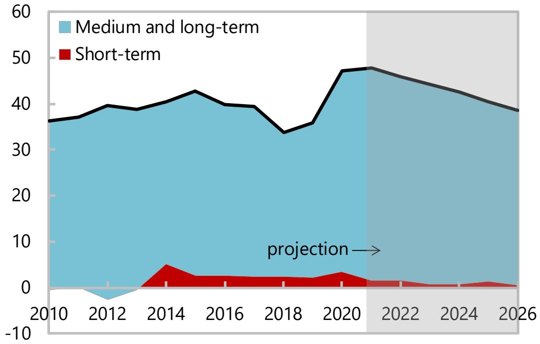
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 1. Lithuania: Public DSA—Composition of Public Debt and Alternative Scenario

Composition of Public Debt

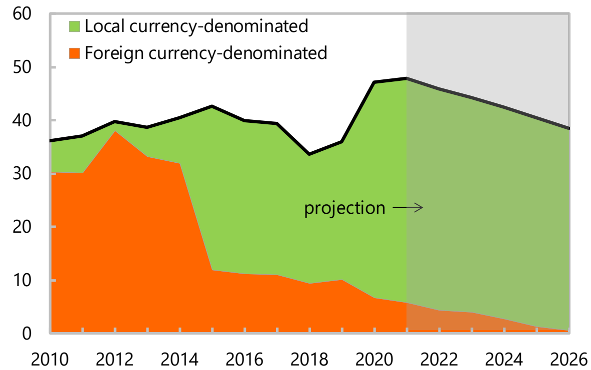
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

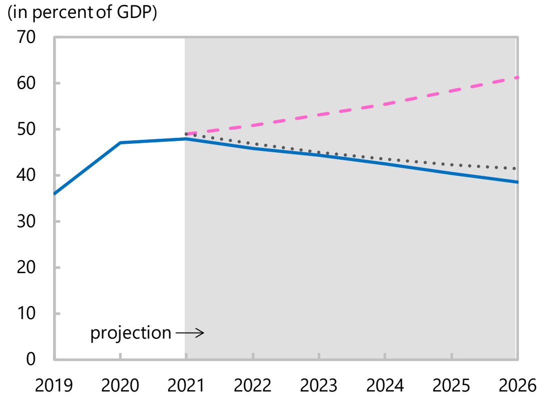


Alternative Scenarios

Baseline Historical Constant Primary Balance

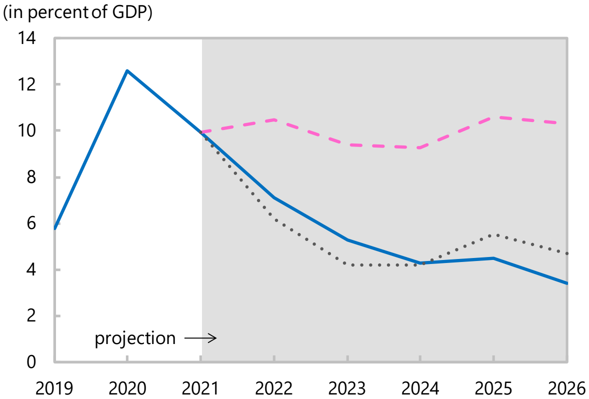
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	4.4	4.1	3.1	2.9	2.6	2.4
Inflation	2.6	2.7	2.6	2.2	2.1	2.1
Primary Balance	-5.3	-2.6	-1.3	-0.9	-0.4	-0.3
Effective interest rate	0.8	0.7	0.7	0.6	0.6	0.7
Constant Primary Balance Scenario						
Real GDP growth	4.4	4.1	3.1	2.9	2.6	2.4
Inflation	2.6	2.7	2.6	2.2	2.1	2.1
Primary Balance	-5.3	-5.3	-5.3	-5.3	-5.3	-5.3
Effective interest rate	0.8	0.6	0.3	0.3	0.7	0.9

Historical Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	4.4	3.3	3.3	3.3	3.3	3.3
Inflation	2.6	2.7	2.6	2.2	2.1	2.1
Primary Balance	-5.3	-0.9	-0.9	-0.9	-0.9	-0.9
Effective interest rate	0.8	0.6	0.7	0.8	1.4	1.9
Contingent Liability Shock						
Real GDP growth	4.4	2.2	1.3	2.9	2.6	2.4
Inflation	2.6	2.2	2.1	2.2	2.1	2.1
Primary Balance	-5.3	-9.2	-1.3	-0.9	-0.4	-0.3
Effective interest rate	0.8	0.7	0.7	0.6	0.9	1.1

Source: IMF staff.

Table 2. Lithuania: External Debt Sustainability Framework, 2016–26

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2016	2017	2018	2019	2020			2021	2022	2023	2024	2025	2026	Debt-stabilizing non-interest current account 6/
Baseline: External debt	81.1	87.9	75.3	65.9	71.3			**62.9**	**58.0**	**54.3**	**51.0**	**48.0**	**45.3**	**-0.6**
Change in external debt	6.7	6.8	-12.6	-9.4	5.4			-8.5	-4.9	-3.7	-3.3	-3.0	-2.8	
Identified external debt-creating flows (4+8+9)	-2.6	-11.9	-11.4	-8.7	-12.5			-12.0	-9.8	-7.8	-6.5	-4.9	-3.6	
Current account deficit, excluding interest payments	-4.3	-5.2	-4.2	-7.2	-11.5			-9.2	-7.6	-6.6	-5.9	-5.2	-4.3	
Deficit in balance of goods and services	-1.2	-2.5	-1.9	-5.2	-9.7			-7.5	-5.5	-4.2	-3.0	-1.9	-0.8	
Exports	74.0	75.0	75.2	77.4	74.1			77.6	76.2	75.6	75.3	75.3	75.5	
Imports	72.7	72.6	73.4	72.2	64.4			70.2	70.7	71.4	72.3	73.5	74.7	
Net non-debt creating capital inflows (negative)	-0.7	-3.3	-1.3	-4.1	-2.8			-2.6	-2.6	-2.7	-2.8	-2.7	-2.8	
Automatic debt dynamics 1/	2.4	-3.4	-5.9	2.6	1.8			-0.2	0.4	1.4	2.2	3.0	3.5	
Contribution from nominal interest rate	5.1	4.6	3.9	3.8	3.2			2.5	2.7	3.1	3.7	4.2	4.6	
Contribution from real GDP growth	-1.8	-3.1	-3.1	-3.2	0.6			-2.8	-2.3	-1.7	-1.5	-1.3	-1.1	
Contribution from price and exchange rate changes 2/	-1.0	-4.9	-6.7	2.0	-2.0			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	9.3	18.7	-1.1	-0.7	18.0			3.6	4.9	4.1	3.2	2.0	0.8	
External debt-to-exports ratio (in percent)	109.6	117.1	100.1	85.1	96.3			81.0	76.1	71.9	67.7	63.8	60.0	
Gross external financing need (in billions of US dollars) 4/	13.4	18.9	23.9	23.2	12.2			13.0	14.2	14.5	15.1	16.5	16.6	
in percent of GDP	31.2	39.6	44.4	42.5	21.8	10-Year	10-Year	20.4	20.4	19.4	19.0	19.7	18.9	
Scenario with key variables at their historical averages 5/								**62.9**	**64.7**	**65.1**	**64.0**	**61.2**	**56.9**	**-0.1**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	2.5	4.3	3.9	4.3	-0.9	3.3	1.8	4.4	4.1	3.1	2.9	2.6	2.4	
GDP deflator in US dollars (change in percent)	1.3	6.4	8.3	-2.6	3.1	1.1	7.8	9.3	5.1	4.0	3.1	2.8	2.5	
Nominal external interest rate (in percent)	7.2	6.3	5.1	5.2	5.0	8.1	2.8	4.0	4.8	5.8	7.1	8.7	10.0	
Growth of exports (US dollar terms, in percent)	1.3	12.6	12.9	4.6	-2.2	6.3	13.8	19.6	7.4	6.3	5.7	5.5	5.1	
Growth of imports (US dollar terms, in percent)	-1.2	10.7	13.8	0.1	-8.9	4.6	14.3	24.3	10.1	8.2	7.5	7.1	6.8	
Current account balance, excluding interest payments	4.3	5.2	4.2	7.2	11.5	6.6	2.8	9.2	7.6	6.6	5.9	5.2	4.3	
Net non-debt creating capital inflows	0.7	3.3	1.3	4.1	2.8	2.1	1.3	2.6	2.6	2.7	2.8	2.7	2.8	

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 deflator).

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.

Annex IV. Timing of Fiscal Stimulus Withdrawal

Supporting the recovery remains the priority until growth is on firm grounds. In the medium term, support should be gradually withdrawn making it more targeted, which will start the process of rebuilding fiscal buffers.

1. **The large fiscal response to the global pandemic highlights the tradeoff between economic stability and debt sustainability.** In the short run, pursuing countercyclical policy to support the economy is the key objective; in the medium term, ensuring debt sustainability and mitigating the potential impact on borrowing costs is also a concern. A large shock as the COVID-19 pandemic, makes balancing these objectives challenging

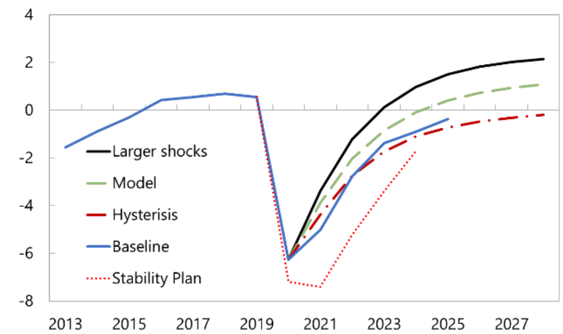
2. **The pace of withdrawal of fiscal support entails a tradeoff between stabilizing the economy and debt sustainability.** The large response to the pandemic in 2020 provided support to households and firms ameliorating the decline in output—which was modest relative to other European economies— and reducing long-term scarring (Annex V). With still heightened uncertainty, significant support is envisaged for 2021 until the recovery is on firm ground. The withdrawal of support is envisaged to accelerate in 2022 as measures are temporary in nature, with the fiscal balance moving back to pre-crisis levels in the medium term.

3. **We use Fournier's buffer-stock model calibrated to Lithuania's economy to assess these trade-offs.**[1] Fournier's (2019) model seeks to balance the need to stabilize the economy through fiscal policy with facing increasing borrowing cost and the risk of losing market access. We calibrated the model to reflect Lithuania's characteristics and emerging market status, including a larger shock size given the larger volatility of the economy, a lower threshold for the risk of losing market access, and a smaller hysteresis effect.

4. **The model suggests that the envisaged pace of stimulus withdrawal under the baseline based on the authorities plans and macroeconomic conditions is broadly adequate.** The model suggests a somewhat smoother pace of adjustment, with a slightly faster withdrawal in 2021 but a more gradual pace in 2022-23, that reduces the risk of a fiscal cliff. The authorities' Stability Plan published last March and based on worse macroeconomic projections and a larger output gap envisages a much slower adjustment and higher debt, but the authorities are in the process of updating their fiscal and macroeconomic plans.

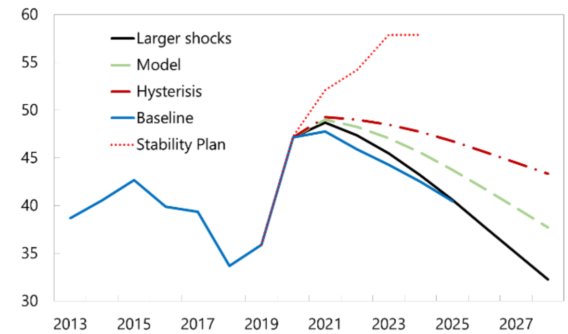
[1] See Fournier, Jean Marc (2019), "A Buffer Stock Model for the Government: Balancing Stability and Sustainability", IMF Working Paper 19/159.

Cyclically Adjusted Primary Balance
(General Goverment, In percent of potential GDP)



Sources: : IMF staff calculations based on the Buffer-stock model of the government (IMF WP 159/19).

Gross Debt
(In percent of GDP)

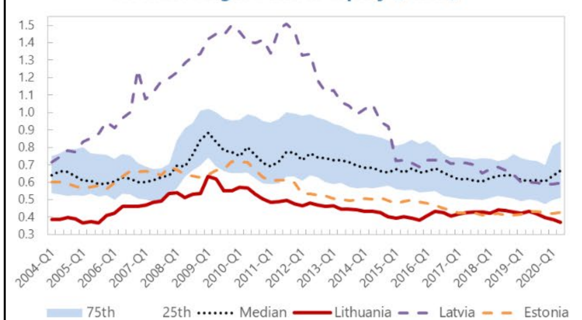


Sources: : IMF staff calculations based on the Buffer-stock model of the government (IMF WP 159/19).

5. **The model highlights the importance of maintaining a counter-cyclical stance, particularly for small open economies with higher volatility like Lithuania.** The results are sensitive to some assumptions. Adding (subtracting) scaring to the model would result in a stronger need to protect the economy which would entail a more (less) gradual pace for stimulus withdrawal and a slower (faster) pace for rebuilding buffers. On the other hand, if one believes that shocks would become more recurrent and result in higher economic volatility, the model suggests a faster stimulus withdrawal in order to rebuild buffers to face future shocks. In the model, the scope for discretionary countercyclical policy—on top of automatic stabilizers—is limited by the increasing cost of debt—including the possibility of losing market access. When there is significant slack, the stabilization role of fiscal policy should have more prominence, but as the slack declines and the economy overheats the relevance of regaining fiscal space and build up buffers increase.

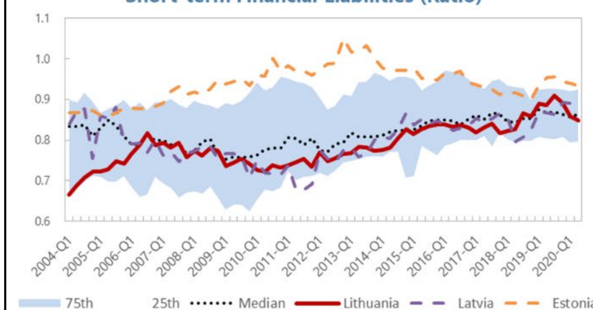
Annex V. Lithuania's Non-financial Corporate Sector and the COVID-19 Pandemic

1. The NFC sector in Lithuania was better prepared for the COVID-19 shock than the GFC due to years of deleveraging and building liquidity buffers. After having increased by over 20 percentage points prior to the GFC, NFC leverage, measured as debt in percent of equity liabilities, has consistently declined since then and remains one of the lowest in Europe. This deleveraging was driven by both a decline in debt and an increase in equity liabilities, noting a shift in firms' financing sources towards equity which could serve as a better shock absorber during times of stress. While deleveraging, NFCs in Lithuania also built liquidity buffers at a slightly faster rate compared to their peers in other European countries.



NFC Leverage: Debt to Equity (Ratio)

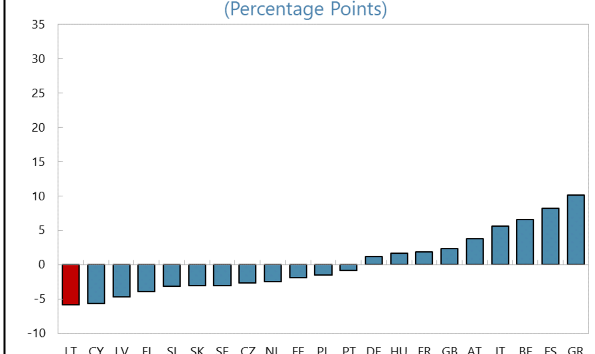
Note: Debt includes debt securities and loans.
Sample includes 24 EU countries, Bulgaria, Denmark, Croatia, and Romania.



NFC Liquidity: Short-term Financial Assets to Short-term Financial Liabilities (Ratio)

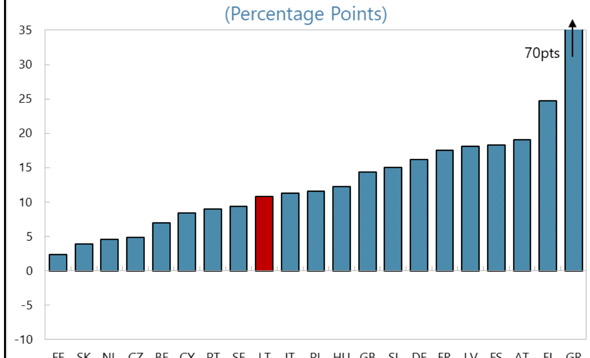
Note: ST assets(liabilities) consist of ST loans, ST debt securities, and total receivable(payable)
Sample includes 24 EU countries, Bulgaria, Denmark, Croatia, and Romania.

2. In turn, the NFC sector demonstrated more resilience during the COVID-19 shock than during the GFC. While NFCs raised their leverage ratios during the GFC, they continued to deleverage during COVID-19 by reducing debt and increasing equity liabilities (Figure 5). Compared to other countries in the region where generally the NFC sector faced less financial burden during the pandemic than during the GFC, Lithuania experienced the largest decline in NFC leverage.



Change in NFC leverage: Pandemic, 2019Q4-20Q4
(Percentage Points)

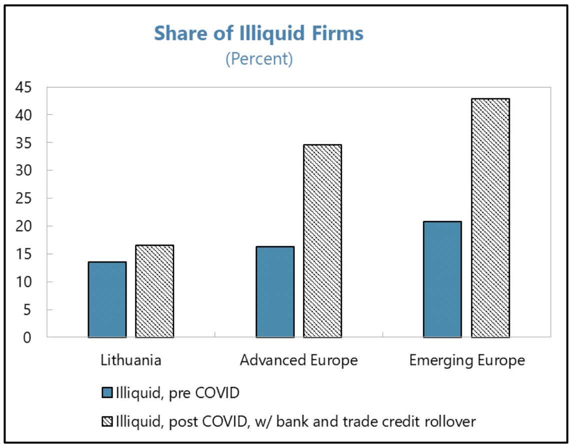
Source. ECB and IMF staff calculations
Note: ECB financial balance sheet data may temporarily differ from national central bank data due to year-end revisions.

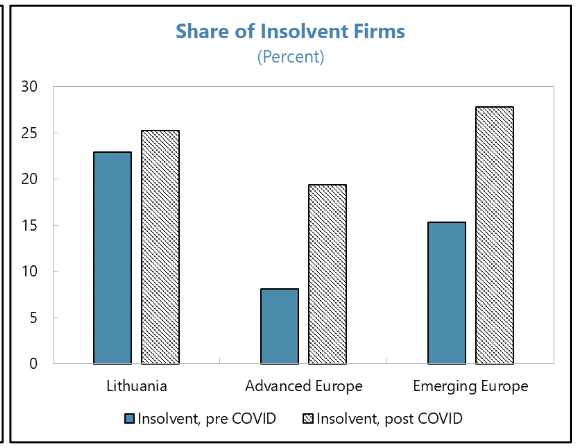


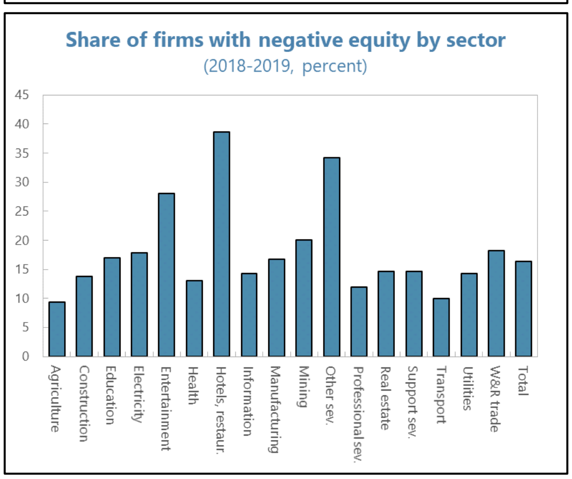
Change in NFC leverage: GFC, 2008Q2-09Q2
(Percentage Points)

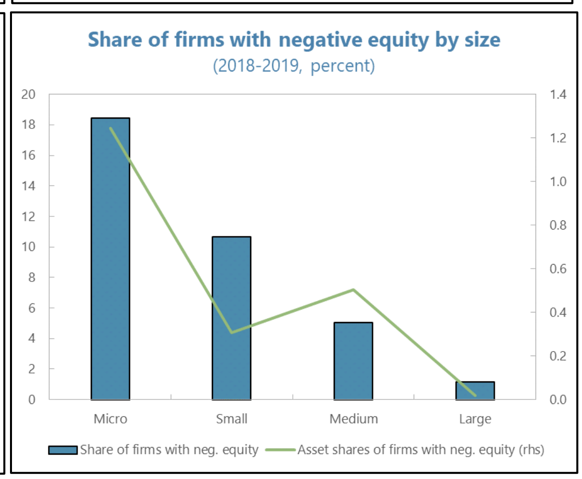
Source. ECB and IMF staff calculations
Note: ECB financial balance sheet data may temporarily differ from national central bank data due to year-end revisions.

3. The resilience of the NFC balance sheets could be explained by an improved pre-crisis position, a different type of crisis compared to the GFC, and counter-cyclical policies. In terms of the balance sheet stress of each individual firm[1], similar to output, the impact of the COVID-19 shock is projected to be much smaller in Lithuania compared to other countries in the region. In the absence of any government support programs, the COVID-19 shock would have led the shares of illiquid and insolvent firms[2] to increase by 3 and 2.4 percent, respectively, compared to 12 to 22 percent in other European countries[3] (text chart[4]). This result can be explained partly by Lithuania's economic structure, which has a smaller share of contact-intensive service sectors, and partly by the deleveraging efforts of NFCs before the pandemic. The number of insolvent firms are expected to remain large in 2021 at about 25.3 percent of the total number of firms. However, most









[1] The rest of the annex presents simulation of corporate balance sheets using firm level data from Statistics Lithuania. We thank the authorities for sharing the administrative database.

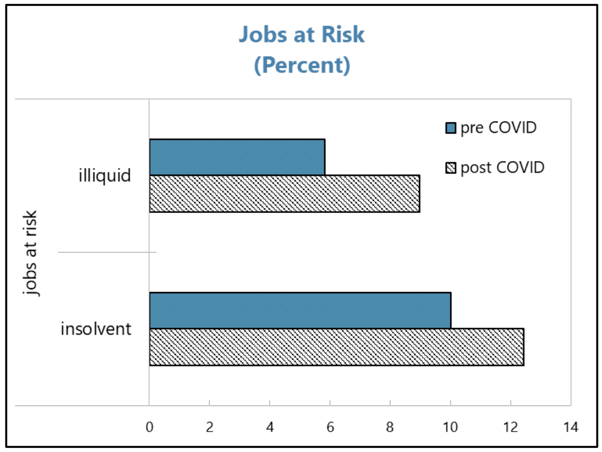
[2] Not weighted by firm size. A firm is defined as illiquid if its liquid assets (cash and financial investments) are insufficient to cover operational net cash outflows and debt repayments (maturing liabilities). Insolvent firms refer to the ones whose book value of debt exceeds the value of assets (in other words, having negative equity).

[3] The "Pre-COVID" scenario assumes a 2.7 percent growth in 2020, based on January WEO 2020. For the simulation approach and results of other European countries, see "IMF, Oct. 2020." "Corporate Liquidity and Solvency in Europe during the Coronavirus Disease Pandemic: The Role of Policies," "Regional Economic Outlook: Europe, Chapter 3."

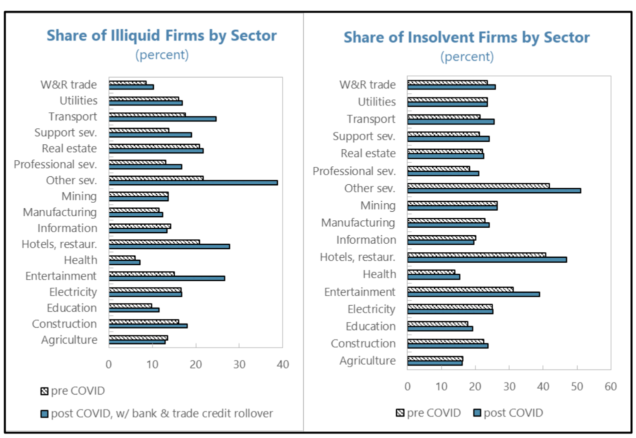
[4] For the post-COVID liquidity scenario, "post COVID, w/ rollover," we assume that both the trade credit market and banks rollover short-term debts. The solvency position of NFCs does not depend on the rollover decisions.

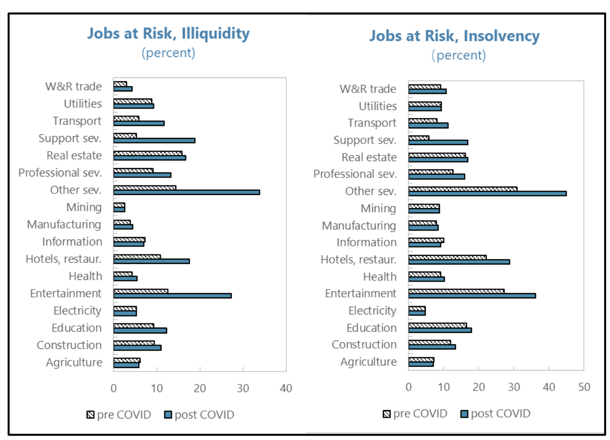
of these firms already had negative equity before the pandemic and they concentrate in micro- and small-sized companies in the entertainment, hotels and restaurants, and other service industries. They only account for roughly 2 percent of the total assets in the entire NFC sector.

4. The impact of the COVID-19 shock on the labor market is also expected to be moderate. We use the metric "jobs at risk" to evaluate the impact of NFC balance sheet vulnerability on the labor market, which refers to the share of workers employed by illiquid or insolvent firms. According to staff calculation, the COVID-19 shock could increase the share of jobs at illiquid NFCs from 5.8 percent to 9 percent, and the share of jobs at insolvent NFCs from 10 percent to 12.4 percent.

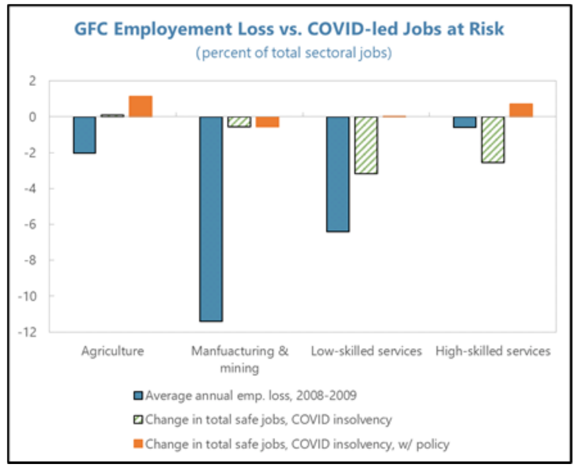


5. Within the NFC sector the impact is heterogeneous, as certain contact-intensive industries are more vulnerable to the shock and the subsequent lockdowns. The sectors hit hardest by the pandemic include hotels and restaurants, entertainment, transportation, and other services. These sectors represent 12.5 percent of total employment and could see a significant worsening in corporate balance sheet health in the absence of government support. Among these sectors, the COVID-19 shock could have led an additional 7 to 17 percent of the firms to become illiquid, and 5 to 10 percent to become insolvent. The shares of jobs-at-risk could have increased from 7 to 20 percent and 7 to 14 percent due to illiquidity and insolvency respectively. The transportation sector, which accounts for 15 percent of total employment, could have, in the absence of policy support, 6 percent more jobs at risk due to illiquidity, and 3 percent more due to insolvency.





6. Given the transitory nature of the COVID shock and the characteristics of the sectors most affected, the impact on employment could be largely temporary. In an economy under structural transformation, such as Lithuania, a transitory demand shock tends to result in large and permanent employment losses only in sectors with downward employment trends, i.e. demand shocks accelerates the underlying structural transformation. Sectors with positive employment trends benefit from the structural transformation so employment would eventually converge back to their pre-shock trends. Unlike the GFC that disproportionately affected manufacturing in Lithuania, the COVID shock has mostly affected sectors with positive employment trends such as high-skilled services, which are unlikely to see permanent scarring.[5] Certain low-skilled service sectors have also had employment losses during the pandemic, but these losses are likely temporary provided the COVID shock is short-lived and these sectors have little firm-specific human capital. Overall, even though the short-term employment losses can be sizeable, long-term labor market impact is likely to be limited compared to the GFC.



7. The authorities' decisive policy response has been effective in preserving corporate sector liquidity and solvency. Support to non-financial corporates include wage subsidies, interest and rent compensation, grants, tax and social contribution deferrals, as well as off-budgetary measures such as guarantees for bank loans (text table, para 15). Lithuania has provided more grant-like supports to the corporate sector compared to the median level in Europe (text chart). The reliance on grant-like measures, such as wage subsidies and sectoral grants, have supported liquidity and preserved equity at the same time. Given the more limited impact of the COVID shock on Lithuania, its corporate sector would, in the absence of policy support, already suffered one of the smallest increases in liquidity or equity shortfalls among European countries. [6] The policy support provided by the authorities further exceeded these shortfalls resulting in an equity and liquidity positions that are stronger than what would have been the case in the absence of the COVID pandemic (text chart). This is the case for every sector regarding liquidity and for most sectors regarding equity, with the exception of manufacturing that was less affected by activity restrictions during the lockdowns and thus, received smaller support.

[5] Lian, Weicheng (2021) "Structural Transformation and Hysteresis in Unemployment in Europe", IMF Working Paper forthcoming.

[6] The liquidity shortfall of the NFC sector is defined as the total amount of cash needed to cover net cash outflows; the equity shortfall of the NFC sector is defined as the total amount of capital required so no NFCs is running with a negative equity on the balance sheet.

8. To summarize, the NFC sector is unlikely to turn the COVID-19 shock into a persistent output loss. The shock itself is expected to have a milder aggregate impact on Lithuania's NFC sector compared to the other countries in Europe and compared to the GFC. Moreover, the impact mostly concentrates in contact-intensive sectors, such as services. Thanks to the timely policy responses and years of deleveraging efforts of NFCs, corporate balance sheets have been preserved and firms' liquidity and solvency conditions appear slightly better compared to the scenario without the COVID-19 shock. The impact on employment and human capital are likely to be transitory as well, given that among the hardest-hit sectors, high-skill services would benefit from long-term structural changes and low-skill services have little firm-specific human capital.

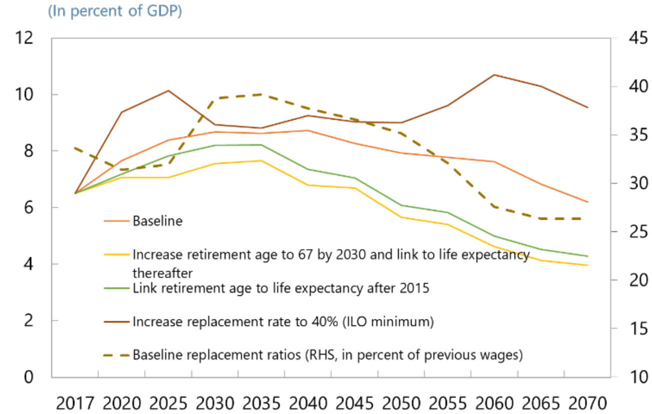
Annex VI. Structural Elements of a Medium-Term Fiscal Strategy

1. To safeguard a strong and credible fiscal position and accelerate convergence, Lithuania needs a credible medium-term fiscal strategy that supports potential growth. The strategy needs to include both revenue and high-quality expenditure measures, have a medium-term perspective and analyze potential risks and policy responses should they materialize. This annex briefly presents an overview of the main elements such a strategy should contain given the challenges faced by Lithuania.

Expenditures

2. Expenditure measures can alleviate pressures from the public wage bill, social benefits, and the pension system. Public sector wages have been growing faster than the private sector (Figure 4) and were over 10 percent larger in 2020. Strengthening the targeted portion of child-care benefits can help reduce child poverty rates, and while reforms to the pension system in 2015 ensured its financial sustainability, still low and declining replacement ratios (40 percent of pensioners are at risk of poverty[1]) risk its social sustainability. The pension system is the most important redistributive social tool in Lithuania.[2] Keeping the replacement ratio constant at 35 percent will cost the budget an additional 7.5 percent of GDP between 2020 and 2025.[3] It is unlikely that these pressures can be accommodated by re-prioritizing spending and will likely require a combination of increased revenues and some parametric reform of the pensions system to—among other things—link the retirement age to life expectancy.

Lithuania: PAYG Pension Expenditure and Replacement Ratio
(In percent of GDP)



Sources: IMF Staff Calculations

3. Improvements in spending efficiency in education along with qualitative reforms of the education system can improve the quality of outcomes. These are currently mixed with good quantitative outcomes but poor qualitative ones. Due to the accessibility of schools and classes, enrollment is very high, putting Lithuania right at the frontier. However, when looking at performance outcomes such as international PISA scores, Lithuania is among the bottom 25 percent of EU countries. Students in Lithuania also perform worse in financial literacy, controlling for

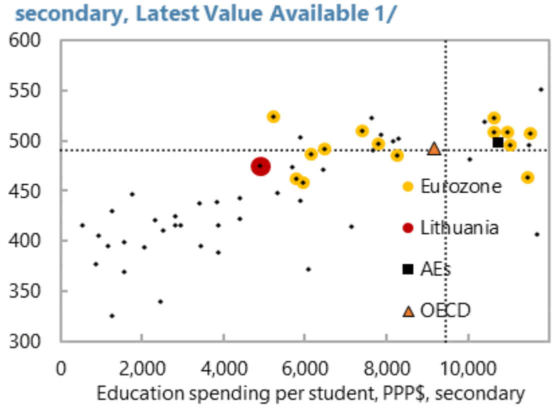
[1] "Social Inequality in Lithuania after the Global Financial Crisis: Evidence from Household Survey Data," Lithuania SIP, 2018.

[2] IMF Country Report No. 19/252.

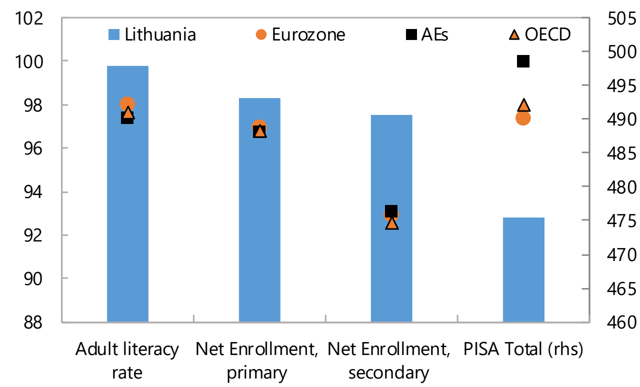
[3] Raising the replacement ratio to 40 percent as recommended by the ILO would require public spending for the PAYG system to increase by around 2 percent of GDP per year. ("Fiscal Challenges in Lithuania," Lithuania SIP, 2018).

performance in mathematics and reading, raising curricular issues. Outcomes of tertiary education also lag those of other EU countries. This is reflected in Lithuania having the third highest level of skills mismatch in the labor market.[4] As rightly emphasized in the education reform package of 2019, Lithuania is focusing on increasing the quality of education as well as the efficiency of the school network. These are steps in the right direction but have not proven ambitious enough to deliver material outcomes. Rationalization of the extensive school network will provide savings that can be redirected to improving school quality, especially for elementary and secondary education. These efforts will help Lithuania catch up with peers and prepare a more productive labor force.

Government Education Spending and Outcome, secondary, Latest Value Available 1/



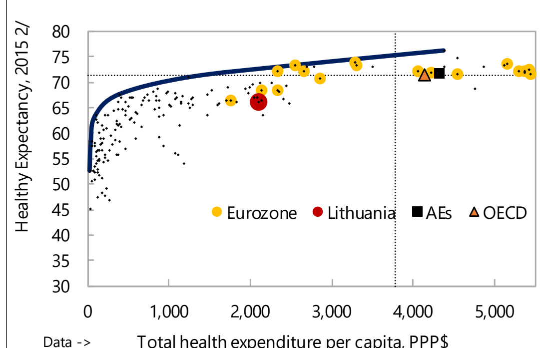
Education Indicators, Latest Value Available



Sources: IMF FAD Expenditure Assessment Tool (EAT), World Bank.
1/Dashlines are the average of Eurozone.

4. Lithuania is far from the health efficiency frontier suggesting that there is substantial scope to improve outcomes within the same spending envelope. For example, Lithuania particularly lags in behavior-related diseases and ranks the lowest in the EU in terms of healthy life expectancy.[5] It has higher rates of smoking, alcohol, heart, and circulatory system related diseases, as well as suicides. Where Lithuania has achieved better outcomes than the EU average is with regards to lowering the number of maternal deaths. Given the preventable nature of these diseases, the stronger focus on primary care and mental health as envisioned in the recent reform plan is appropriate. Increases in excise taxes—particularly alcohol and tobacco—can be considered to discourage unhealthy behavior. These measures can potentially increase the healthy life

Health Efficiency Frontier, Latest Value Available 1/



Source: IMF FAD Expenditure Assessment Tool (EAT), World Bank, World Health Organization.

1/ Dashes are the average of Eurozone.

2/ Healthy life expectancy (HALE) is a measure of health expectancy that applies disability weights to health states to compute the equivalent number of years of life expected to be lived in full health.

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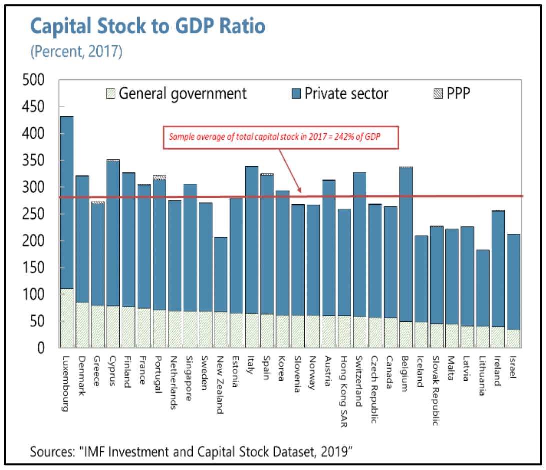
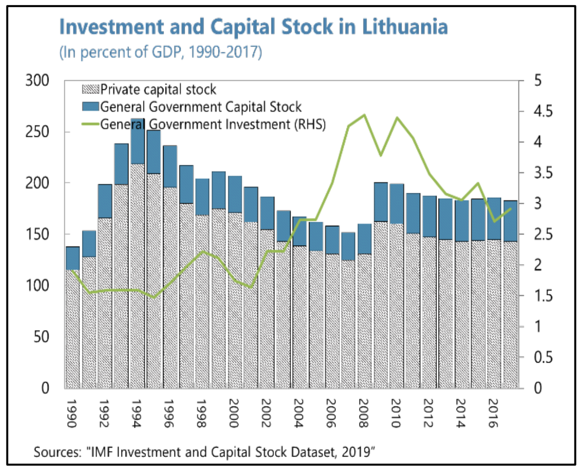
[4] Skills Mismatch and Active Labor Market Policy in Lithuania, Lithuania Selected Issues Paper 2019.

[5] Healthy life expectancy adjusts standard life-expectancy measures for severity of illnesses and quality of life factors.

expectancy in Lithuania to that of peer countries (some seven years higher) even within a similar spending envelope.

5. Public investment has been around 3 percent per year for the past five years, resulting in no growth in the capital stock. To close this infrastructure gap, Lithuania could consider increasing its investment rate over the medium-term. An alternative is to front-load some of this capital accumulation. Front-loading investments can have a lasting positive impact with more positive externalities even if the initial waste is slightly higher. Lithuania should take full advantage of low interest rates, EU structural funds and new RRF resources However, excessive front-loading could be counter-productive if the pace exceeds the absorptive capacity of the economy, resulting in some crowding-out, investment inefficiencies, and higher debt accumulation.[6]





Revenues

6. Tax revenue measures can improve the efficiency of the taxation system and raise revenues, strengthen credibility, and support competitiveness. Tax revenue in Lithuania as a percentage of GDP is below that of most of its peers in the EU and the OECD. Furthermore, structural revenue declined by almost 3 percent of GDP between 2005 and 2018. Several factors can explain low tax revenues in Lithuania, including weak compliance in value added taxes that result in a VAT gap of 2.5 percent of GDP,[7] relatively low tax rates, greater reliance on indirect taxes, and low capital and wealth taxes.

7. Changes to the tax system and their impact on the business environment and competitiveness should not be considered in isolation from other relevant factors. FDI flows to Lithuania as a share of GDP are lower than those to Estonia and just slightly higher than in Latvia. Meanwhile, studies have shown that the quality of institutions is an important determinant for FDI

[6] Unleashing Israel's Potential: Is Boosting Public Investment the Answer?, Israel SIP, 2018.

[7] "Study and Reports on the VAT Gap in the EU-28 Member States: 2020 Final Report", European Commission, 2020.

and that the sensitivity of FDI to tax rates varies significantly with institutional quality.[8] For example, Estonia has higher perceived institutional quality while having both higher CIT and FDI.[9]

8. The current tax system continues to lean heavily on indirect taxes, and with an emphasis on labor taxes among direct taxes. Past recommendations have included shifting the tax burden away from labor taxes into wealth and environmental-related taxes. This shift would increase the efficiency of the tax system and could also result in higher revenues. Changing the distortionary two-rate CIT to a single rate could also be considered as well as the tax incentives in the relatively large number of free economic zones with generous multi-year CIT exemptions. Regarding tax administration, improvements in this area alone will not be able to meaningfully raise revenue**.** Closing the VAT gap closer to the level in Latvia or Estonia could get Lithuania more than 1 percent of GDP. While there is scope to reduce tax expenditures, the level in Lithuania at 3 percent of GDP is not an outlier compared to other EU countries.[10]

Lithuania's Tax Revenue Underperformance, 2018

(In percent of GDP)

	Lithuania	EU-28	*Difference*
Total tax revenues	29.9	39.0	*-9.1*
Personal income tax	4.1	9.5	*-5.4*
Corporate income tax	1.5	2.7	*-1.2*
VAT	7.8	7.1	*0.6*
Excises and consumption taxes	3.2	2.2	*0.9*
Taxes on land, buildings, and other structures	0.2	1.1	*-0.9*
Social security contributions	13.0	13.3	*-0.3*
Other	0.1	3.0	*-2.8*

Sources: Statistical Office of the European Communities and Haver Analytics.

Current Taxes on Income and Wealth, 2018

(In percent of GDP)

	Lithuania	Estonia	Latvia	Sweden	UK	EU-28
Current taxes on income, wealth, etc.	5.7	7.4	7.4	18.6	13.9	13.2
Personal income tax	4.1	5.4	6.0	15.0	8.7	9.5
Corporate income tax	1.5	0.3	1.1	3.1	2.6	2.7
Current taxes on capital	0.0	…	0.0	0.0	0.2	0.3
Payments by household for licenses	0.0	…	0.2	0.4	0.4	0.2
Other	0.0	1.7	0.0	0.1	2.0	0.5

Sources: Statistical Office of the European Communities and Haver Analytics.

[8] Taxation and the Quality of Institution: Asymmetric Effects on FDI, Taxation Papers, European Commission, 2010.

[9] "Institutional quality as a determinant of FDI inflow: the case of Central and Eastern European countries," Journal of Management and Financial Services, 2019.

[10] Fiscal Transparency Evaluation Report, Lithuania, 2018.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LITHUANIA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 28, 2021

Prepared by European Department

CONTENTS

FUND RELATIONS

(As of May 31, 2021)

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)	413.58	93.65
Reserve Tranche Position	28.03	6.35

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	137.24	100.00
Holdings	137.40	100.12

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				
	2021	2022	2023	2024	2025
Principal		0.00	0.00	0.00	0.00
Charges/Interest		0.00	0.00	0.00	0.00
Total		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:

The currency of Lithuania is the euro. The exchange rate arrangement of the euro area is free floating. Lithuania participates in a currency union (EMU) with 18 other members of the EU and has no separate legal tender. The euro, the common currency, floats freely and independently against other currencies. Lithuania has accepted the obligations of Article VIII of the Fund's Articles of Agreement and maintains an exchange system free of multiple currency practices and restrictions on the making of payments 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 June 25, 2019. The staff report and other related documents are available at https://www.imf.org/en/Publications/CR/Issues/2019/07/30/Republic-of-Lithuania-2019-Article-IV-Consultation-Press-Release-Staff-Report-48537.

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, 1999–2021

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. 3–26, 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
FAD	Fiscal Transparency	Mission	Nov. 28–Dec. 11, 2018	Ministry of Finance
FAD	High Wealth Individuals Management	Mission	Feb. 25–Mar. 30, 2021	State Tax Inspectorate

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 assessed by MONEYVAL, the FATF-style regional body of which it is a member, in April 2012 and December 2018. The former 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. While Lithuania has made progress on criminalizing ML/FT, it remained subject to regular follow-up. At the MONEYVAL Plenary in September 2017, the Plenary agreed that Lithuania has taken sufficient steps to remedy deficiencies on key and core FATF recommendations which resulted in Lithuania being removed from the regular follow-up process. At the MONEYVAL Plenary in December 2018, Lithuania's 5th round mutual evaluation was adopted, with all moderate effectiveness ratings except one (substantial) and a set of recommendations to be addressed by the 2020 plenary session, including an update of the National Risk Assessment.

Lithuania made a number of improvements on the AML/CFT front in 2020. The government adopted resolution regarding the establishment of the AML Centre of Excellence, which is designed to facilitate information sharing and strengthen collaboration among key stake holders. A National Risk Assessment (NRA) was completed in 2019 and the report was published in 2020. Based on the NRA report, a draft plan for the measures to mitigate the risk of ML/TF for the 2021-2023 was prepared and in consultation with competent authorities. The Bank of Lithuania has also approved a new policy for AML/CFT supervision and the ML/TF Risk Scoring Methodology against ML/TF risks.

Lithuania has transposed the 5th Anti Money Laundering and Terrorist Financing Directive on January 10, 2020. The new legislation, among other things, makes public the registers of beneficial owners of companies (and under some conditions trusts) operating within the EU and improves interconnectedness of member countries' national registers. Virtual currencies and custodian wallet providers are included into the scope of Directive. The amendment of the Law on the Prevention of Money Laundering and Terrorist Financing VIII-275, which emphasizes the prevention, detection, investigation or prosecution of serious criminal offences, was adopted by the Seimas and should enter into force on August 1, 2021.

STATISTICAL ISSUES

(As of June 28, 2021)

I. Assessment of Data Adequacy for Surveillance

General: Over the past several years, Lithuania has made good progress in establishing a macroeconomic database. Data provision to the Fund is adequate for surveillance purposes.

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.

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 index reference period for both the CPI and the HICP is 2015. The monthly CPI and HICP are available in the second week following the reference month. The consumer 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. Annual and quarterly historical data have been converted into the GFSM 2014 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 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. Lithuania participates in the Eurostat GFS convergence project with the IMF since 2012.

Monetary and Financial Statistics: Lithuania uses the ECB reporting framework for monetary statistics, and data are reported to the IMF through a gateway arrangement with the ECB that provides for efficient transmission of monetary statistics to the IMF and for publication in the IFS. IFS coverage includes the central bank and other depository corporations (ODCs) using Euro Area wide and national residency criteria. Data are published in IFS with a lag of about a month. Lithuania reports some data and indicators of the Financial Access Survey (FAS), including two indicators of the United Nations Sustainable Development Goals. There is room for improvement in reporting to the FAS, especially for series on use of financial services (depositors, deposit accounts, borrowers, and loan accounts).

Financial sector surveillance: Lithuania reports all 12 core and 8 of the 13 encouraged financial soundness indicators (FSIs) for deposit takers, three FSIs for nonfinancial corporations, one FSI for households, and all four FSIs for real estate markets on a quarterly basis. Reporting of one FSI for deposit takers and one FSI for real estate markets was discontinued since 2018.

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. Lithuania reports comprehensive data to two STA initiatives: (i) the Coordinated Direct Investment Survey (CDIS); and (ii) the Coordinated Portfolio Investment Survey (CPIS). 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.

II. Data Standards and Quality

Lithuania is an adherent to the Special Data Dissemination Standard Plus (SDDS Plus) since July 2018, and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB). Lithuania's latest SDDS Plus Annual Observance Report is available on the DSBB.

The ROSC data module was published on December 2002.

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, and 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.lrv.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 June 28, 2021

	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	March 2021	Feb 2021	M	M	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	April2021	June 2021	M	M	M		
Reserve/Base Money	April 2021	June 2021	M	M	M	O, LO, LO, LO	O, O, LO, O, O
Broad Money	April 2021	June 2021	M	M	M		
Central Bank Balance Sheet	April 2021	June 2021	M	M	M		
Consolidated Balance Sheet of the Banking System	April 2021	June 2021	M	M	M		
Interest Rates[2]	April 2021	June 2021	M	M	M		
Consumer Price Index	May 2021	June 2021	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2021Q1	June 2021	Q	Q	Q	LO, LO, LO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2021Q1	June 2021	Q	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2020Q4	June 2021	M	M	M		
External Current Account Balance	2020Q4	April 2021	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	2021Q1	June 2021	Q	Q	Q		
GDP/GNP	2021Q1	June 2021	Q	Q	Q	O, LO, O, LO	O, LO, LO, LO, O
Gross External Debt	2020Q4	June 2021	Q	Q	Q		
International Investment Position[6]	2020Q4	June 2021	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.

Statement by Mr. Pösö, Executive Director, and
Mr. Spurga, Advisor to the Executive Director
August 25, 2021

The Lithuanian authorities highly appreciate the continuation of the constructive, candid, and productive engagement with the Fund staff, as well as the insightful and well-balanced report for the 2021 Article IV consultation. Our authorities agree with the thrust of staff's findings and recommendations, which are broadly in line with their own assessment and policy priorities. The authorities also emphasize their commitment to multilateralism, as well as their deepening engagement in the Fund's financial initiatives: in 2018, Lithuania became a participant in the FTP; in 2020, Lithuania joined the new BBAs; and currently, Lithuania is in the process of joining the VTAs.

Outlook

The Lithuanian economy displayed resilience in the face of the COVID-19 crisis. The -0.8 percent contraction in 2020 was among the lowest in Europe. The robust performance was underpinned by strong fundamentals and a track record of prudent fiscal and financial sector policies that prevented the emergence of macroeconomic imbalances prior to the pandemic shock. Moreover, decisive policy response provided a timely lifeline to businesses and preserved jobs and incomes of the affected households. The decline in manufacturing activity was short-lived, with manufacturing output surpassing the pre-COVID level already in July 2020, and exports recovering quickly in the second half of last year.

The latest data releases suggest a firm economic recovery is taking place. Very strong GDP growth in both Q1 and Q2 (1.4 and 8.6 percent year-on-year, SA) reflect Lithuania's ability to adapt to the COVID-19 environment, the resilience of the manufacturing sector, the unrestricted movement of goods during the lockdown period, as well as strengthening private consumption. Also, the share of tourism-related activities is relatively small in the Lithuanian economy, which has limited the negative economic impact of the pandemic.

The role of the tradable sector in the economic recovery underlines the importance of preserving free international trade, which is key for small open economies like Lithuania. In the face of the global pandemic, Lithuania substantially increased its exports of medical reagents that are used to manufacture vaccines and therapy products. The expanded production capacity in this area is likely to positively contribute to the economy's potential in the medium-to-long term as well. Road freight exports have also proved resilient. However, the development of the transportation sector may be challenged going forward by the EU's Mobility Package requirements. The authorities agree with staff that some rules of the package appear at odds with the spirit of the EU Single Market and are not in line with the EU's Green Deal and climate commitments.

On the back of easing restrictions to economic activity, the near-term outlook remains favorable, although uncertainty remains. Increasing vaccination rates and an improved epidemiological situation allowed for the easing of lockdown measures, which boosted household consumption and formed the basis for a recovery of contact services. Strong external and domestic demand is already positively impacting consumer sentiment and corporate expectations, thus increasing private investment which has declined significantly over the past year. Overall, robust recovery in the first half of the year, favorable external environment, and the reopening of the economy allow to expect a rapid economic growth in 2021. However, even though the situation has stabilized, it has to be closely monitored. The authorities stress that the uncertainty regarding the future still remains high due to the spread of COVID-19 variants.

The economic growth will go hand-in-hand with increasing wages in both private and public sectors, adding to the purchasing power of the working population. The Ministry of Finance projects a 7.9 % annual growth in average monthly gross wages in 2021. Wage growth will continue to be supported by the ongoing recovery in the labor market, with the unemployment rate further declining by 1.1 percentage points year-on-year to 7.4 percent in Q2, 2021. The authorities will also uphold personal incomes through increasing social benefits aimed at the vulnerable parts of the society, as well as financial assistance for workers affected by the pandemic restrictions.

The projected pickup in domestic demand will increase imports, correcting the temporarily strengthened external position. Although exports posted a strong recovery in the latter half of 2020, the rebound in imports was subdued, improving the current account balance in line with previous experiences of Lithuania during recessions. A significant drop in domestic demand and interruptions on the supply side impeded business expansion plans and negatively affected investments and inventory accumulation, which put downward pressure on import volumes. At the same time, a good harvest season led to agricultural products that do not depend on imported resources dominating Lithuanian exports especially in Q3, 2020. Looking ahead, the current account surplus is expected to decline gradually with the rebound in private consumption and private investment, as well as the restoration of inventories. Overall, the authorities agree that the external position will converge to the level implied by fundamentals over the medium-term.

The near-term inflation risks remain contained. The recovery in economic activity, combined with temporarily higher energy and other raw material prices will have an upward effect on prices. However, as bottlenecks in the global supply chains and global imbalances between supply and demand in raw materials dissipate, inflationary pressures are expected to ease.

While managing risks related to the pandemic, the authorities will also pay close attention to the medium-term challenges. As the recovery gains ground, the authorities will remain vigilant in monitoring upside risks and maintaining a carefully calibrated fiscal stance to preserve the macroeconomic stability. At the same time, sustained productivity growth in the tradable sector, as well as a relatively low labor share of income compared to peers in the region mitigate the immediate concerns over the effects of possible inflationary pressures stemming from labor cost developments.

Fiscal policy

The authorities broadly concur that strong fiscal support likely prevented the long-term scarring effects of the pandemic. Policy space available going into the pandemic shock enabled the authorities to provide the necessary support to households, businesses, and the healthcare system, with the greatest share in support measures coming in the form of transfers to corporates through wage subsidies. In 2020, financial assistance has been more focused on the broad provision of liquidity and solvency support to stabilize the economy. Since the beginning of this year, the provision of support to the real economy has become more targeted to those affected.

The authorities remain committed to provide short-term policy support to ensure a continued economic recovery and an appropriate response to the COVID-19 related risks. This year's budget has earmarked around EUR 1.8 bn for mitigation of the effects of the pandemic and unexpected shocks. The measures foreseen range from subsidy support and interest compensation to preserve business and jobs to compensation for overtime of officials and medical staff. The revised budget approved by the Parliament in June also foresees additional funding for vaccines and the vaccination process, wage supplements for medical staff, as well as additional financing for education, transport, and tourism sectors which have been severely affected by the pandemic. To address the government's social priorities and the situation for the most vulnerable groups of the society, additional funds were also earmarked for universal single person benefits, as well as for the employment of people with disabilities. The proposed reduction of the VAT rate for the negatively affected sectors that include catering services, sports, cultural, and recreation is also foreseen as a temporary measure with an engrained sunset clause.

The pace of withdrawal of fiscal policy support will be dictated by the strength of the recovery underway, as well as further developments with the spread of the virus. Given the transitory nature of short-term support measures, the level of public debt will stabilize over the medium-term, although staying higher compared to the pre-pandemic period. The authorities are revisiting the tax system to improve the structure of taxes and social benefits, thus contributing to the reduction of income inequality, as well as planning to develop an action plan to reduce the shadow economy and the VAT gap. The authorities also note that the revised budget based on the updated macroeconomic projections envisages a faster fiscal adjustment in comparison to the March projection, thus narrowing the gap with staff's fiscal projections. The Ministry of Finance now projects the general government deficit to amount to -6.7 % of GDP in 2021, with the general government debt reaching 49.3 % of GDP (compared to staff's forecast of -5.5 and 47.7 % of GDP respectively).

Financial sector

In addition to a wide range of fiscal measures, Lithuania has employed an array of macroprudential, regulatory, and supervisory measures to ensure financial stability. In line with the intended functioning of the framework, the Bank of Lithuania acted proactively and fully released the countercyclical capital buffer in March 2020. Overall, the relaxation of microprudential (such as the Pillar II Guidance) and macroprudential requirements have increased the lending potential of financial institutions. The central bank also encouraged the signing of moratoria on the postponement of credit commitments for private individuals and non-financial corporations. Going forward, the banking sector has ample liquidity and capital buffers to support a strong recovery.

The authorities are ready to employ macroprudential policies proactively to preserve stability. Although an increase in housing market activity is observed, the sector's growth is estimated to be in line with fundamentals. Moreover, lending standards are not loosening and continue to be underpinned by LTV and DSTI requirements for mortgage lending. However, if any signs of overheating of the housing market emerge, targeted macroprudential tools will be employed. For instance, Bank of

Lithuania is prepared to consider the introduction of the sectoral systemic risk buffer on housing loan portfolios.

At this stage of the fintech sector growth, which has continued over the course of the pandemic, the authorities emphasize quality rather than quantity. The aim of the authorities is to fully reap the potential of fintech to reduce concentration in the national financial sector, provide access to alternative financing sources for residents and businesses, and create high-skill jobs. With these objectives in mind, the authorities are preparing a new five-year fintech development strategy to ensure the maturity of the fintech sector and further strengthen the risk management framework. At the same time, the authorities stress that Lithuania does not yet have large online banks with a non-resident business model, and the immediate risks in this area remain theoretical.

Further strengthening of the AML/CFT framework remains at the forefront of the authorities' agenda. The Bank of Lithuania has substantially boosted human resources devoted to this area as a follow-up to the MONEYVAL recommendations. The central bank has also been applying strict enforcement measures for violations of the AML/CFT requirements and has been consistently increasing the number of inspections. Lithuania is also among the eight countries of the Nordic-Baltic Constituency that have taken the initiative to engage the IMF to conduct an independent regional analysis of the money laundering and terrorist financing threats and vulnerabilities, with findings tentatively expected in mid-2022. In May 2021, the Centre of Excellence in Anti-Money Laundering started its activities in Lithuania, a public-private partnership effort made possible by the cooperation of multiple government agencies, the Bank of Lithuania, as well as commercial banks.

Structural reforms

Authorities fully agree with staff's assessment of Lithuania's structural challenges. These include social and regional disparities, a sub-optimal quality of public services, as well as unfavorable demographic trends. As the ageing process accelerates, the working-age population will continue to decrease, negatively impacting employment levels. These issues require strong potential output growth to preserve competitiveness, ensure the continued economic convergence, and create the fiscal space to meet social demands.

The authorities are committed to implement an ambitious structural reform agenda to address the persistent long-term challenges, in line with staff's recommendations. The Government's program, its action plan and the "Next Generation Lithuania" plan all together create an ambitious and comprehensive reform package. It will tackle long-term structural changes by accelerating the green and digital transformation of the economy, focusing on the supply of better education, health and social services, and supporting private and public investment and productivity growth. The "Next Generation Lithuania" plan, financed by the EU Recovery and Resilience Facility (RRF), will be an important driver of public investment in the country and will be directly linked to structural reforms, including those recommended by staff and other international institutions over the recent years. The RRF funds amount to EUR 2.23 bn of the total EUR 17.1 bn earmarked investments for social-economic development in the 2021-2030 National Development Plan. Together with other EU and national funds, they form a coherent package of investments. The results of the macro-modelling carried out by the authorities show a strong impact of the measures outlined in the "Next Generation Lithuania" plan on economic activity, as real GDP over the period 2022-2026 is expected to be 1.7 % higher per year on average. The planned reform and investment package will also positively contribute to improving climate change-related indicators, labour market dynamics, and poverty reduction.