INTERNATIONAL MONETARY FUND

IMF Country Report No. 23/316

REPUBLIC OF LITHUANIA

2023 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF LITHUANIA

September 2023

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 2023 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 28, 2023 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 28, 2023, following discussions that ended on July 13, 2023, with the officials of the Republic of Lithuania on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 18, 2023.
- 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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International Monetary Fund
Washington, D.C.

PRESS RELEASE

PR23/301

IMF Executive Board Concludes 2023 Article IV Consultation with the Republic of Lithuania

FOR IMMEDIATE RELEASE

Washington, DC – September 5, 2023: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Lithuania on August 28, 2023.

Lithuania weathered a series of unprecedented external shocks, owing to resilient macroeconomic fundamentals and a decisive policy response. Recently, however, high inflation and rising interest rates have affected disposable incomes which, combined with weak external demand, resulted in an economic contraction in the last quarter of 2022 and early 2023. At the same time, the labor market has remained broadly resilient with high wage growth, albeit negative in real terms, and has supported domestic demand for a year until July.

Headline inflation increased at an annual average of 19 percent in 2022—one of the highest in the eurozone, along with Estonia and Latvia. While the rate of inflation is falling rapidly due to lower energy prices and base effects to around 10 percent in May from a peak of 23 percent in September last year, it remains significantly above the eurozone average. Core inflation, excluding energy and unprocessed food, remains very high, reflecting supply bottlenecks, higher commodity prices, and the robust recovery of demand after the pandemic, pointing to still fairly broad-based price pressures.

The economy is expected to recover later this year and next supported by domestic and external demand. On balance, risks are tilted to the downside with persistently higher inflation than the Euro Area as the biggest risk. On the domestic front, current deviations of wages from productivity can be accommodated given large past competitiveness gains provided they are transitory. However, if inflation remains high for longer, inflation expectations might adjust upwards, perpetuating high rates of price and wage growth that would eventually erode competitiveness. On the external front, an escalation of Russia's war in Ukraine could trigger higher energy and food prices leading to an increase in inflation. In this scenario, the authorities' response should not interfere with price signals and provide targeted support to the most vulnerable. On the upside, the economy could prove more resilient than projected given the strength of private sector balance sheets, strong underlying fundamentals and an external demand that could recover quicker than projected.

[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]

In concluding the 2023 Article IV consultation with the Republic of Lithuania, Executive Directors endorsed staff's appraisal, as follows:

Executive Directors welcomed the authorities' policies that have contributed to the resilience of the economy. However, while Lithuania continues to benefit from strong fundamentals, Directors pointed out that high inflation and rising interest rates weakened disposable income which, combined with weak external demand, resulted in a temporary contraction of economic activity.

They encouraged the authorities to mitigate the risk of high and persistent inflation by tightening the fiscal stance while preserving public investment. To this end, the reactivation of the domestic fiscal rule will help contain inflation risks and gradually rebuild fiscal buffers. Directors also acknowledged that accommodating new and pre-existing spending pressures will likely require new revenues under the existing fiscal rule that can be simplified and adjusted to accommodate permanently higher defense spending.

They noted that a weakening economy and higher interest rates impose risks to the financial sector, but banks are in a position to manage these risks given high liquidity, capitalization, and profitability. While macroprudential measures could be eased in the event of a sharp downturn, a number of Directors stressed the importance of building buffers further. Directors also encouraged the authorities to keep the levy on banks temporary to avoid being perceived as a levy on foreign investment and minimize the potential negative impact on efficiency. With a maturing Fintech sector, Directors emphasized the need to continue enhancing supervisory capacity and the AML/CFT framework.

They highlighted the importance of preserving the flexibility of the economy and advancing long-overdue structural reforms, including through full and timely implementation of the country´s Recovery and Resilience Plan. They welcomed the recent civil service reform and underscored the need to accelerate reforms in the healthcare and education sectors that will be critical to support further productivity gains and higher living standards. Furthermore, Directors agreed that developing renewable sources of energy and improving energy efficiency are necessary for climate change mitigation and energy security. To this end, Directors encouraged the authorities the application of a carbon tax in sectors not covered by the EU's Emission Trading System (ETS).

[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.

Table 1. Lithuania: Selected Economic Indicators, 2018-2028

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
						Projections					
Output											
Real GDP growth (annual percentage change)	4.0	4.6	0.0	6.0	1.9	-1.4	2.9	2.7	2.5	2.2	2.1
Domestic demand (contribution to growth)	3.3	1.3	-3.8	6.7	1.3	-1.1	2.7	2.6	2.3	2.1	1.9
Domestic demand growth (y/y, in percent)	3.4	1.5	-3.8	7.0	1.6	-1.2	2.9	2.8	2.5	2.2	2.1
Private consumption growth (y/y, in percent)	3.6	2.7	-2.5	8.0	0.5	-0.4	2.9	2.8	2.5	2.2	2.0
Domestic fixed investment growth (y/y, in percent)	10.0	6.6	-0.2	7.8	2.6	3.0	3.7	3.5	3.2	3.0	2.8
Inventories (contribution to growth)	-1.1	-1.6	-1.9	0.0	0.6	-1.8	0.0	0.0	0.0	0.0	0.0
Net external demand (contribution to growth)	0.7	3.3	3.8	-0.7	0.6	-0.2	0.2	0.2	0.2	0.2	0.2
Export growth (y/y, in percent)	6.8	10.1	0.4	17.0	11.9	-1.7	4.6	4.8	5.0	5.1	5.0
Import growth (y/y, in percent)	6.0	6.0	-4.5	19.9	12.3	-1.6	4.7	5.0	5.3	5.3	5.1
Nominal GDP (in billions of euro)	45.5	48.9	49.8	56.2	66.8	72.1	77.9	83.0	87.6	91.8	96.0
Potential GDP growth	3.6	3.7	2.3	2.6	2.2	1.5	2.5	2.4	2.2	2.2	2.2
Output gap (percent of potential GDP)	0.2	1.2	-1.1	2.2	1.9	-1.1	-0.7	-0.3	0.0	0.0	0.0
Employment											
Employment (annual percentage change)	1.5	0.3	-1.5	0.8	3.8	-2.8	0.2	0.1	0.1	-0.1	-0.1
Unemployment rate (year average, in percent of labor force)	6.1	6.3	8.5	7.1	5.9	7.8	6.7	6.2	6.0	6.0	6.0
Average monthly gross earnings (annual percentage change) 1/	9.9	8.8	10.1	10.5	11.3	11.9	8.5	6.2	5.0	5.1	5.1
Average monthly gross earnings, real (annual percentage change)	7.2	6.4	9.0	5.6	-6.4	2.3	4.5	3.3	2.4	2.6	2.6
Labor productivity (annual percentage change)	2.5	4.3	1.5	5.2	-1.9	1.5	2.7	2.6	2.4	2.3	2.2
Prices											
HICP, period average (annual percentage change)	2.5	2.2	1.1	4.6	18.9	9.6	4.0	3.0	2.6	2.5	2.4
HICP core, period average (annual percentage change)	2.1	2.5	2.5	3.2	13.6	10.8	4.7	3.2	2.6	2.5	2.4
HICP, end of period (y/y percentage change)	1.8	2.7	-0.1	10.7	20.0	4.1	3.0	2.9	2.5	2.5	2.5
GDP deflator (y/y percentage change)	3.5	2.7	1.9	6.3	16.7	9.4	5.0	3.8	2.9	2.5	2.4
General Government Finances											
Revenue (percent of GDP)	34.5	35.2	36.1	36.4	35.8	38.1	36.7	36.1	35.5	35.6	35.5
Of which EU grants	0.7	0.9	0.7	0.6	0.7	1.1	0.4	0.5	0.3	0.3	0.3
Expenditure (percent of GDP)	34.0	34.7	42.6	37.5	36.5	40.1	38.2	37.3	36.7	36.6	36.5
Of which: Non-interest	33.1	33.9	41.9	37.1	36.1	39.6	37.6	36.5	35.9	35.8	35.7
Interest	0.9	0.9	0.7	0.4	0.4	0.5	0.6	0.8	0.8	0.8	0.8
Fiscal balance (percent of GDP)	0.5	0.5	-6.5	-1.2	-0.6	-2.0	-1.5	-1.2	-1.1	-1.0	-1.0
Fiscal balance excl. one-offs (percent of GDP)	0.5	0.4	-6.6	-1.2	-0.6	-2.0	-1.5	-1.2	-1.1	-1.0	-1.0
Structural fiscal balance (percent of potential GDP) 2/	0.5	0.0	-6.1	-2.0	-1.3	-1.6	-1.2	-1.0	-1.1	-1.0	-1.0
General government gross debt (percent of GDP)	33.7	35.8	46.3	43.7	38.1	36.7	35.0	33.5	32.4	31.5	30.8
Of which: Foreign currency-denominated	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance of Payments (in percent of GDP, unless otherwise specified)											
Current account balance	0.3	3.5	7.3	1.1	-5.1	-2.2	-1.5	-1.1	-0.6	-0.2	0.8
Current account balance (billions of euros)	0.1	1.7	3.6	0.6	-3.4	-1.6	-1.1	-0.9	-0.5	-0.2	0.7
Saving-Investment Balance (in percent of GDP)											
Gross national saving	20.6	21.3	21.3	20.8	21.7	21.6	22.7	23.7	24.7	25.3	26.0
Gross national investment	20.4	17.7	14.0	19.6	26.7	23.7	24.2	24.8	25.2	25.5	25.2
Foreign net savings	-0.3	-3.5	-7.3	-1.1	5.1	2.2	1.5	1.1	0.6	0.2	-0.8

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.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LITHUANIA

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

July 18, 2023

KEY ISSUES

Context. The strong post-pandemic recovery led to demand driven inflationary pressures. Supply side bottlenecks and large increases in commodity prices after Russia's invasion of Ukraine compounded these pressures and resulted in high and persistent inflation. The negative impact on disposable income, higher interest rates and weaker external demand have led to a deterioration of economic activity. If high inflation becomes entrenched, it will erode competitiveness and slow the successful convergence process. The financial system has ample liquidity and capital buffers to address the weakening economic cycle. Higher interest rates have boosted banks' profitability, but they also bring significant risks.

With monetary conditions that are too loose for Lithuania, the onus to fight inflation and maintain competitiveness is on fiscal policy and structural reforms. Short-term policies should aim at reducing inflationary pressures and preserving financial stability. Long-term policies should focus on implementing long-overdue structural reforms that remain key to raising further the economy's growth potential supporting faster income convergence with Western Europe.

Key Policy Recommendations Include:

- **Fiscal policy needs to take a disinflationary stance.** This will require a lower-than-budgeted deficit this year, notwithstanding a weakening economy and a contractionary stance going forward in line with the domestic fiscal rule.
- **Financial policies should address risks from higher interest rates and volatile markets.** Potential non-systemic vulnerabilities need to be proactively monitored.
- **Implement long-overdue structural reforms to strengthen education and healthcare and to address risks associated with climate change.** Utilize EU funds efficiently to enhance private sector productivity.

Approved by
Helge Berger (EUR) and Bergljot Barkbu (SPR)

Discussions were held in Vilnius during May 31–June 13, 2023. The team comprised Messrs. Borja Gracia (head), Serhan Cevik, Philipp Engler, and Ms. Alice Fan (all EUR). Mr. Vitas Vasiliauskas (OED) participated in most of the meetings. Mses. Kelly MacKinnon and Sadhna Naik (all EUR) supported the mission from headquarters.

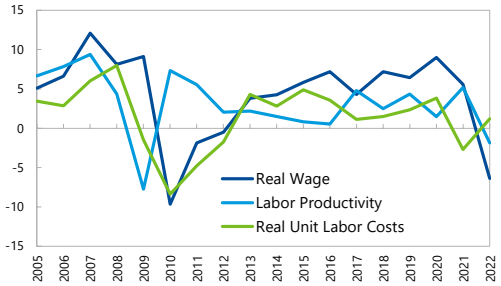
CONTENTS

ANNEXES

CONTEXT: UNPRECEDENTED SHOCKS AMIDST A SUCCESSFUL CONVERGENCE PROCESS

1. Lithuania has experienced a successful income convergence particularly after the global financial crisis (GFC). The strong post-GFC policy response of fiscal and nominal wage adjustment boosted competitiveness and set the stage for an export boom that has steadily raised exports' market share by about 60 percent since 2008. Although real wages have increased significantly across the economy, sustained productivity growth, particularly in the tradeable sector, has kept unit labor costs competitive and contributed to a strong competitive position (see Annex V). As a result, Lithuania's per capita income has reached 92 percent of the EU average.

Wage, Productivity, and Unit Labor Cost Growth
(Percent)



Sources: European Commission; Statistics Lithuania; Haver Analytics; and IMF staff calculations.

2. The pandemic and Russia's war in Ukraine reinforce the importance of prudent policies and labor market flexibility to deal with shocks. Ample policy buffers and the safety net provided by European institutions, particularly after joining the eurozone, have been key to provide stability and predictability. Thus, the private sector entered these shocks with abundant buffers. First, despite negative real income growth, consumer spending remained resilient thanks to a strong labor market and unprecedented fiscal transfers during the pandemic and with energy subsidies last year. Second, nonfinancial corporates have low leverage and maintain a high level of profit margins providing flexibility to adjust during economic turbulences and cost shocks.

Pre War vs. Pre GFC vs. Pre Covid

	2007	2019	2021
Current Account (percent GDP):	-13.3	5.2	2.6
Savings-Investment balances:			
Non-financial corporates	-9.0	5.5	1.8
Households	-4.4	-1.5	1.0
General government	-0.8	0.5	-1.0
Financial corporates	0.9	0.7	0.7
Output gap (percent potential GDP)	13.4	1.2	2.2
Nominal wage growth 1/	18.6	8.8	11.3
Inflation 2/	11.1	2.2	18.9
Budget balance (percent GDP)	-1.0	0.3	-1.0
Structural balance (percent potential GDP)	-6.3	0.0	-2.0
Effective interest rate on public debt 3/	7.0	2.8	1.1

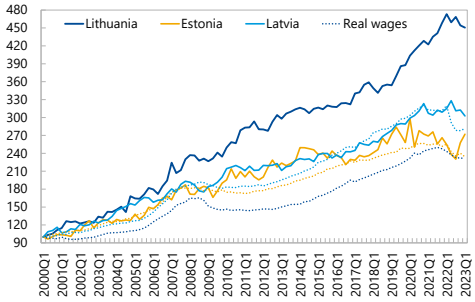
Sources: Eurostat, Haver, IMF staff calculations
1/ 2019 excludes tax and pension reform adjustment
2/ 2008, 2019 and 2021
3/ 2009, 2019 and 2021

3. With limited policy tools, high inflation—50 percent above the eurozone average—risks becoming entrenched, impacting competitiveness. The robust post-pandemic recovery resulted in stronger demand driven inflationary pressures than in the eurozone before the war. Subsequently, the war generated large supply-side inflationary pressures contributing to second-round effects notwithstanding the large decline in energy prices since last August. Furthermore, a tight but weakening labor market has added to cost-push inflation with high wage growth—although negative in real terms for the last year—increasing the risk of persistently high inflation. High wage growth, in turn, if delinked from productivity growth and sustained over time, could erode competitiveness. However, Lithuania's labor market is flexible with wages being largely determined at the firm level. In contrast to the GFC, the absence of macroeconomic imbalances and the strong competitive position provide flexibility to absorb temporary deviations of wages from productivity. However, monetary conditions, determined largely by the European Central Bank (ECB), have

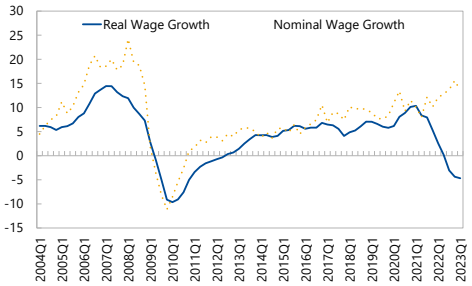
tightened but remain looser than warranted by domestic conditions. Thus, the onus in terms of domestic policies to contain inflationary risks lays on fiscal policy.

Competitiveness and Convergence

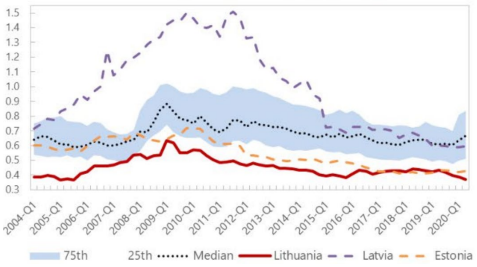
Productivity and Real Wages in Tradables 1/
(Index; 2000Q1 = 100)



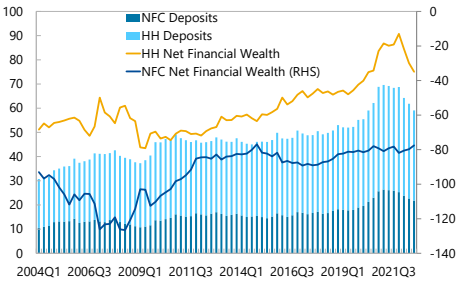
Real and Nominal Wage Growth
(in percent, year-on-year change)



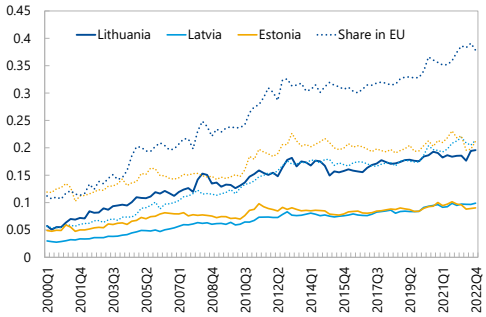
NFC Leverage: Debt to Equity 2/
(Ratio)



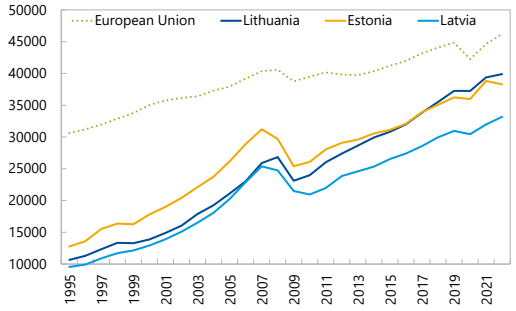
Private Sector Balance Sheet
(Percent of GDP)



Share of World Exports
(Percent)



GDP Per Capita
(in PPP 2017 international dollars)



Sources: World Economic Outlook, IMF; and IMF staff calculations.

Source: World Economic Outlook, IMF; Haver Analytics; Bank of Lithuania; Statistics Lithuania; and IMF staff calculations.

1/ Tradables include agriculture, foresty, fishing and manufacturing.

2/ Debt includes debt securities and loans. Sample includes 24 EU countries, Bulgaria, Croatia and Romania.

Box 1. Drivers of Export Success: Price Competitiveness and Growing Sophistication

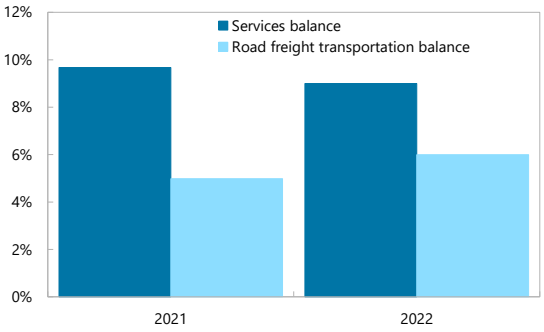
Beyond cost advantages, Lithuania's exports increased in complexity, likely providing some protection from last year's energy shock. The country's ranking in the economic complexity index of the Center of International Development at Harvard has increased by ten points in the decade to 2020, showing a growing

Box 1. Drivers of Export Success: Price Competitiveness and Growing Sophistication
(concluded)

degree of sophistication, diversity of products, and international interconnectedness of large parts of Lithuania's export sector. This development was driven by growing human capital, technological progress, and growing networks. The gains in export performance since the GFC thus went beyond mere increases in price competitiveness. Combined with a highly flexible labor market and a low-cost business environment, this part of the export sector should be well positioned to withstand a temporary energy price shock.

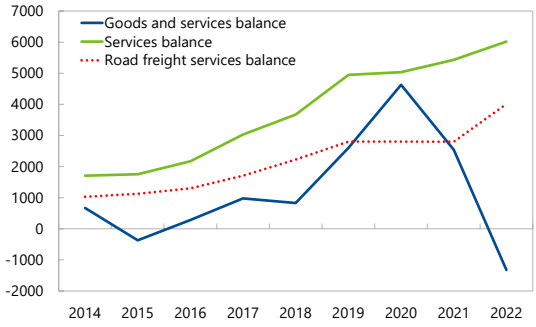
The transportation sector has made significant gains in external markets since 2014—even after the war started and the EU mobility package was approved. Net exports increased by one percentage point of GDP in 2022. The growth in the sector accelerated after Russia's annexation of Crimea and the subsequent sanctions forced to shift towards the EU market in 2014, rendering the sector the main driver of the large and increasing services trade surpluses. This performance was driven by substantial cost advantages vis-à-vis other European economies. Taxes and charges on road transportation in Lithuania are the lowest in the EU, partly reflecting vehicle taxation unrelated to carbon emissions. Furthermore, labor unionization is modest and taxes are more competitive. Lithuanian road transportation companies' revenues stand at 90 percent of their overall business with most activity conducted in the EU and the UK. This being a low-margin business, Lithuanian low-cost companies gained business when skyrocketing fuel prices drove up costs across the EU.

Services Exports and Road Freight
(Percent of GDP)



Sources: Bank of Lithuania; and IMF staff calculations.

Freight Services in International Trade
(Mil. Euros)



Sources: Bank of Lithuania; and IMF staff calculations.

RECENT DEVELOPMENTS: WEAKENING ACTIVITY, PERSISTENT INFLATION AND GEOPOLITICAL RISKS

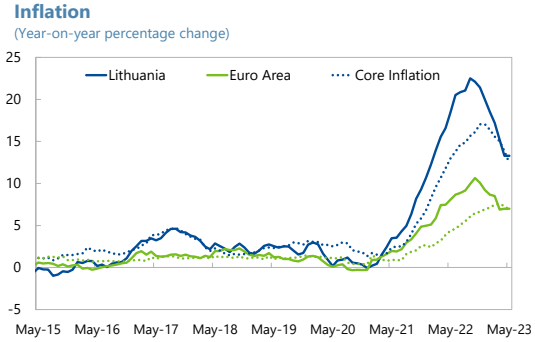
4. The economy remained resilient to the negative terms-of-trade shock until the last quarter of 2022 amid high inflation and global uncertainties. Lithuania started 2022 with strong growth and continuous signs of overheating. However, the economy started weakening in the last quarter of 2022 and, particularly, in the first quarter of this year amidst high inflation, heightened uncertainty, weak external demand and tightening financial conditions that impacted private consumption and private investment. External demand, while softening, was stronger-than-expected. At the same time, the labor market has remained broadly resilient with high wage growth,

although negative in real terms. The influx of refugees from Ukraine—of 80,000 refugees, around 20,000 have found a job out of 1.4 million total employment—has helped moderate some of the labor-market bottlenecks.

5. Economic links to Russia have decreased significantly, limiting the direct impact of the war. The share of exports to Russia, Ukraine, and Belarus was 18 percent as of end-2021, down from 29 percent in 2014 before the introduction of sanctions and countersanctions due to Russia's annexation of Crimea. In 2022 this share further declined to 12 percent. However, re-exports account for a significant share of this, particularly in the case of Russia, around 90 percent.

Source: Statistics Lithuania; and IMF staff calculations.

6. Inflation, while falling, remains high in spite of tightening monetary conditions. Inflation increased at an annual average of 19 percent in 2022, one of the highest in the eurozone, along with Estonia and Latvia. Reflecting global supply-chain pressures, higher commodity prices and the robust recovery of demand after the pandemic. Core inflation, excluding energy and unprocessed food, is equally high, indicating broad-based inflation pressures. Lower energy prices and base effects have lowered inflation rates rapidly recently—11 percent in May from a peak of 23 percent in September last year—but it remains 5 percentage points above the eurozone average.



Source: Eurostat; and Haver Analytics.

7. With energy prices decreasing, domestic energy tariffs are now broadly consistent with full pass-through of import prices. Lithuania depends heavily on imported energy, especially natural gas. The authorities took a pragmatic approach to the energy crisis by letting the price signal work, particularly for businesses, while preventing potentially costly macroeconomic disruptions by subsidizing part of the price increase and scaling up support to the vulnerable. This had a large fiscal cost, amplified by the untargeted nature of subsidies, around 1.3 percent of GDP in 2022 and 0.3 percent of GDP in the first quarter of 2023. However, with electricity prices decreasing rapidly since last August and below subsidized levels since January this year, in the absence of shocks, there will be no further electricity subsidies. Some gas subsidies to households—reflecting hedging operations taken when prices were high—remain until the end of the year at a modest fiscal cost (0.07 percent of GDP).

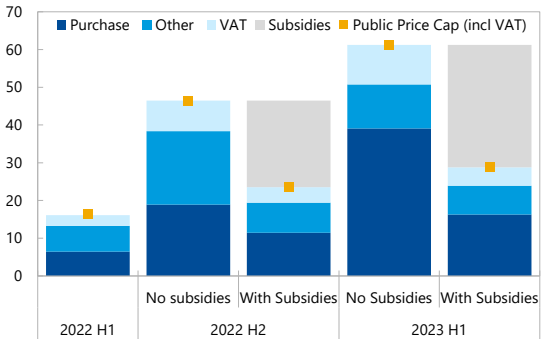
8. The fiscal stance in 2022 was moderately counter-cyclical, marginally contributing to containing inflationary pressures. The budget deficit—originally projected at 3.3 percent of GDP—narrowed to 0.6 percent of GDP from 1.2 percent in 2021 and 6.5 in 2020. A resilient economy, windfall revenues from high inflation (estimated at about 0.5 percent of GDP) and lower-than-planned spending on energy subsidies were the main contributing factors. Public debt remains

comfortably low, below 40 percent of GDP in 2022—from 46.3 percent in 2020. As a result, Lithuania maintains substantial fiscal space with low risk of sovereign stress over the medium-term (Annex IV).

Energy Prices and Subsidies

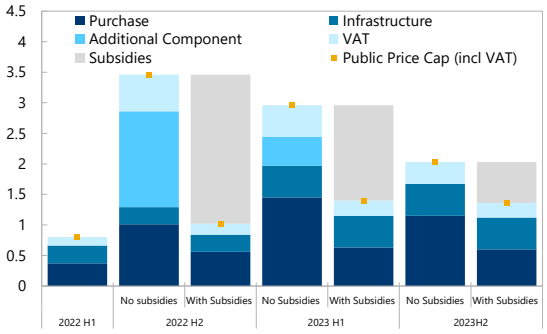
Household Retail Electricity Price

(Euro cent/kWh)



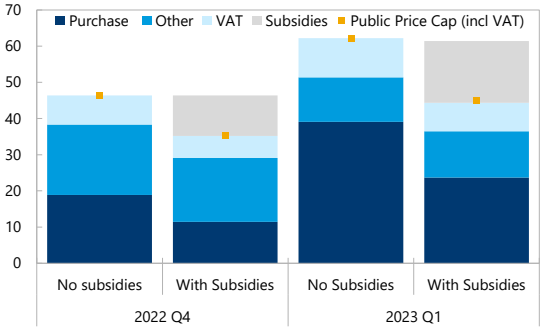
Household Retail Gas Price

(EUR/m3; gas used for heating)



Business Retail Electricity Price

(Euro cent/kWh)



Energy Subsidy and Tariff

(in EUR millions; unless otherwise specified)

Period	Sector	Full Tariff	Tariff Faced by Consumer	Subsidized Tariff	Actual/Projected Costs (% of GDP)
2022H2	**Gas**				
	Household	3.46	1.02	2.44	0.5
	Businesses			No Subsidy	
	Electricity				
	Household	0.46	0.24	0.23	0.6
	Businesses	0.46	0.35	0.12	0.2
2023H1	**Gas**				
	Household	2.96	1.4	1.56	0.2
	Businesses			No Subsidy	
	Electricity				
	Household	0.56	0.28	0.28	0.1
	Businesses	0.56	0.42	0.14	0.01
2023H2	**Gas**				
	Household	2.03	1.36	0.67	0.07
	Businesses			No Subsidy	
	Electricity				
	Household			No Subsidy	
	Businesses				

Source: VERT and EmergingMarketWatch

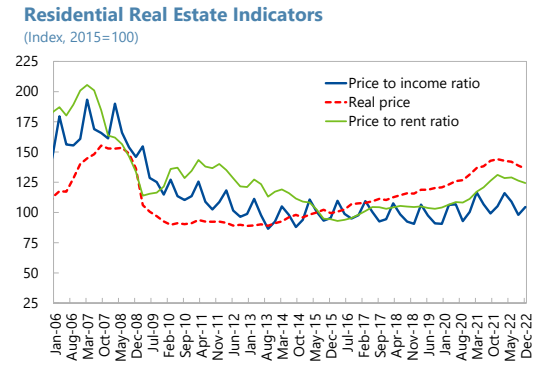
9. Domestic demand and higher lending rates are supporting higher profitability of the banking system. Capital ratios are well above regulatory requirements (19 percent CAR), especially for systemically important banks, while NPL ratios are low and have continued to decline. The rapid pace of deposit accumulation during the pandemic has continued, raising the amount of bank deposits excluding non-residents from 54 percent of GDP at end-2019 to 62 percent of GDP by end-2022. With ample liquidity—390 percent liquidity coverage ratio—banks have been slow to increase deposit rates. However, they are benefiting from higher interest rates on new loans and the repricing of variable-rate mortgages that account for the great majority of the portfolio.

10. Macroprudential policy has been tightened as risks from volatile financial markets and higher interest rates increased. The low stock of mortgages (around 20 percent of GDP), the large share of transactions in cash (60 percent by value) and the relatively low average loan-to-value ratio

suggest that the quantitative impact on households will be limited and the monetary transmission weaker than could have been expected. To address risks from the real estate market, the Bank of Lithuania (BoL) took measures including to increase the Countercyclical Capital Buffer (CCyB) from 0 to 1 percent in September 2022 effective October 2023. This decision reflected their assessment that the financial cycle, particularly for mortgages, was in an expansionary phase.

11. Lithuania's financial system is undergoing a structural change driven by Fintech companies and the rapid ex pansion of Revolut. Since starting to operate as a bank by end-2019, Revolut has become the third biggest bank in Lithuania with 18 percent of system-wide assets. With an online banking model, it relies on non-resident EU depositors (98 percent of total deposits). The rapid increase in deposits (12 percent of GDP at end-2022) largely matches the increase in liquidity held at the BoL (10 percent of GDP). At the same time, the increase in the lending portfolio is much more timid (0.3 percent of GDP). While expected to be supervised by the Single Supervisory Mechanism (SSM) soon, Revolut's deposits are covered by Lithuania's deposit insurance fund. After an exponential expansion since 2014, the Fintech sector is consolidating with no growth in the number of companies operating in Lithuania from 2021 to 2022, around 260.

12. The real estate market is undergoing an adjustment after years of gains that accelerated during the pandemic. The rapid growth of real estate prices was largely explained by fundamentals before 2020—particularly the rapid growth of disposable income. However, given accommodative monetary conditions, large fiscal support, and the resilience of the labor market, growth accelerated during the pandemic to levels not fully justified by fundamentals. From 2010 to end-2022, house prices increased more than 140 percent—the third highest rate in the EU. With higher borrowing costs and weakening economic activity, the pace of nominal increase in property prices has slowed down to 14 percent as of April 2023 from an average of 21 percent in 2022. Prices are converging to, but remain above, levels consistent with fundamentals (Annex VIII).

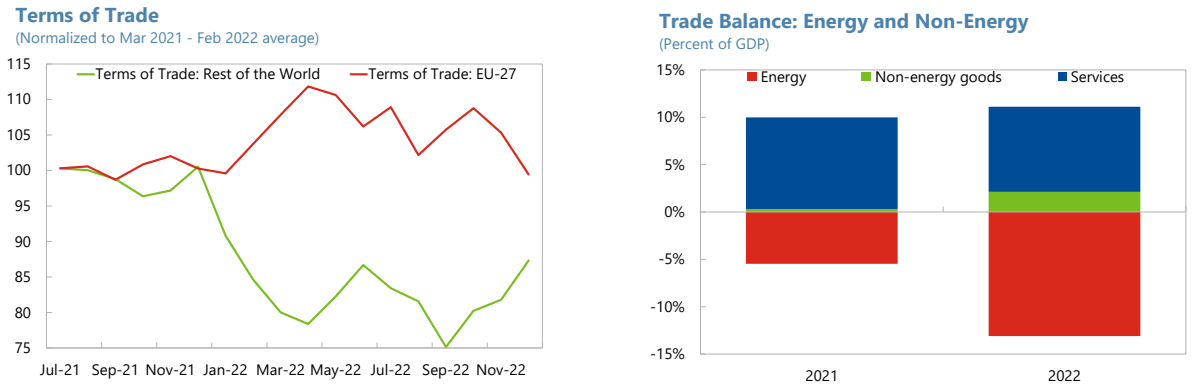


Sources: Bank of International Settlements; Haver Analytics; Eurostat, and IMF staff calculations.

13. The massive but transitory energy price shock deteriorated the trade balance but, so far, not price competitiveness vis-à-vis Lithuania's main trading partners. Lithuania experienced a 20 percent decline in the terms-of-trade relative to countries outside the EU last year. With a heavy reliance on energy imports, the energy trade balance deteriorated by 7.6 percentage points of GDP, from -5.5 percent of GDP in 2021. However, the non-energy trade balance improved by 1.4 percentage points of GDP. Notably, the trade balance with other EU countries that were hit by a similar shock and are Lithuania's main trading partners, improved by 2.2 percentage points. This suggests that the underlying competitive strength of the economy has not deteriorated to date. However, some sectors have been affected on a more permanent basis and will need to adjust to the new environment—such as the furniture industry and its reliance on low-cost lumber from

Belarus. The economic slowdown in Lithuania and the euro area since late-2022 has compressed both exports and imports so far this year.

Terms of Trade and the Current Account



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

14. Lithuania's external position was substantially weaker than fundamentals in 2022 (Annex III). The current account balance deteriorated strongly turning into a deficit of 5.1 percent in 2022. This deterioration was driven by a massive increase in net energy imports. Since most of the deterioration of the terms-of-trade is largely temporary, the current account is expected to converge over time to its norm under the current baseline.

OUTLOOK AND RISKS

15. The economy is expected to experience a recession in 2023 given the weak momentum from late-2022 and early-2023 but with activity strengthening in the second half of the year. The baseline projections assume no further escalation of the war and a gradual decline in commodity prices that remain above pre-war levels.

- **Inflation will remain elevated for longer.** Notwithstanding lower global energy and food prices and the recent slowdown, a weakening but still tight labor market and second round effects will result in more persistent inflation throughout this year and next. Thus, disinflation—driven by falling energy prices and weakening activity—is expected to be gradual towards the equilibrium level moderately above the euro area average given the convergence process.

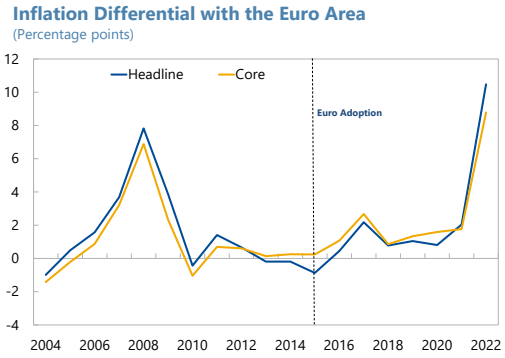
- **Activity will be weak in the first half of the year with softening domestic and external demand, and a weaker labor market.** With lower inflation and a resilient labor market, both domestic and external demand are expected to recover later this year and next also supported by high public investment financed by EU funds. Potential output should be only marginally affected from the recent shocks if inflationary risks do not materialize.

Main Macroeconomic Variables Under Baseline, 2022-2028 (in percent)							
	2022	2023	2024	2025	2026	2027	2028
Real GDP growth	1.9	-1.4	2.9	2.7	2.5	2.2	2.1
Output gap	1.9	-1.1	-0.7	-0.3	0.0	0.0	0.0
Inflation	18.9	9.6	4.0	3.0	2.6	2.5	2.4
Core Inflation	13.6	10.8	4.7	3.2	2.6	2.5	2.4
Unemployment Rate	5.9	7.8	6.7	6.2	6.0	6.0	6.0
Wage Growth	11.3	11.9	8.5	6.2	5.0	5.1	5.1
Pre-war real GDP growth projections	*3.9*	*3.1*	*2.6*	*2.4*	*2.3*	*2.3*	

16. The baseline is highly uncertain with risks—mostly external—tilted to the downside (Annex I):

- **Low growth-low inflation risks:** Financial stability risks are associated with uncertain and volatile financial markets that could also trigger a disorderly correction of the real estate market. In response to demand shocks that lower growth and inflation relative to the baseline, the authorities should let automatic stabilizers operate and, if needed, provide targeted and timebound support.

- **Low growth-high inflation risks:** On the domestic front, the biggest risk is persistently higher inflation than the euro area. Current deviations of wages from productivity can be accommodated given large past competitiveness gains provided they are transitory. However, if inflation remains high for longer, inflation expectations might adjust upwards, perpetuating high rates of price and wage growth that would eventually erode competitiveness. On the external front, the escalation of the war could trigger higher energy and food prices leading to higher inflation. In this scenario, the authorities' response should not interfere with price signals and provide targeted support to the most vulnerable. Other external risks include high volatility of commodity prices, financial sector instability and geo-economic fragmentation.



Sources: World Economic Outlook, IMF; and IMF staff calculations.

- **On the upside, the economy could prove more resilient** than projected given the strength of private sector balance sheets, strong underlying fundamentals and an external demand that could recover quicker than projected.

Authorities' Views

17. The authorities broadly agree with staff's assessment of the outlook and risks and highlight the resilience of the labor market. They acknowledge the uncertainties coming from

external factors and expect low or negative export growth this year as well as a somewhat faster convergence of inflation to its target. They see lower inflation and high wage growth supporting consumption and emphasize that high public investment this year will support activity. They agree with the assessment on inflation risks but caution that evaluating monetary conditions as being too loose is subject to uncertainty in a converging economy such as Lithuania. Regarding trade sanctions against Russia, they stressed that some sectors have been particularly affected as key production inputs need to be sourced at higher costs but are confident that, as in the past, Lithuanian companies can absorb this shock maintaining their competitiveness.

POLICY DISCUSSIONS: FIGHTING INFLATION AND PRESERVING STABILITY WITH LIMITED POLICY TOOLS

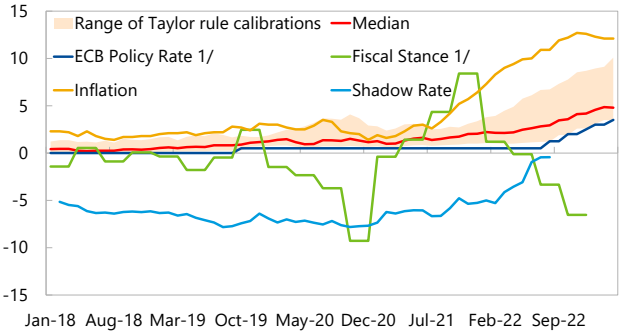
Persistent high inflation is the biggest risk facing Lithuania. Therefore, fiscal policy should support the disinflationary effort. At the same time, financial policies should continue to be used proactively to preserve stability. Over the medium-term, implementing structural reforms is the only way to support further productivity gains. In any case, short-term challenges should not be addressed by introducing long-term distortions that reduce the structural flexibility of the economy.

A. An Appropriate Policy Mix to Reduce Inflationary Risks and Preserve Macroeconomic Stability

Fiscal Policy

18. Fiscal policy has an important role to play in containing the risks from high and persistent inflation (Annex V). External factors tend to be the dominant driver of inflation in the Baltics, but domestic factors play an important role as well. In this context, the ECB's monetary tightening—aimed at bringing inflation back to target in the euro area as a whole—came late, starting more than a year after inflation began to pick up. Although monetary conditions have become significantly more restrictive, they remain loose relative to local economic conditions. Thus, fiscal policy is the main macro-stabilization tool available and, although its effectiveness is reduced by the openness of Lithuania's economy, it should be used proactively to reduce inflationary pressures.

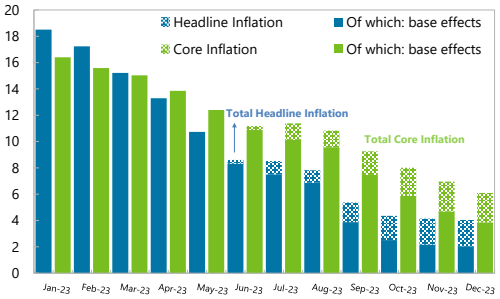
Taylor Rules for Lithuania
(Percent)



Sources: European Commission; Eurostat; Haver Analytics; and IMF staff calculations.
1/ ECB policy rate is the main refinancing operations rate and fiscal stance is measured as y/y change in cyclically-adjusted primary balance in percent of potential GDP.

19. The decrease of energy prices is contributing to lowering inflation and decreasing spending on subsidies. Thus, from a budget appropriation of 1.3 percent of GDP, subsidies will be less than 0.4 percent of GDP this year. Going forward, import prices should be fully passed through to consumers and no new subsidies should be provided.

Inflation Base Effects 1/
(Percent)



Sources: Eurostat; and IMF staff calculations.
1/ Assuming zero month-on-month inflation.

20. The latest Stability Program projects a fiscal relaxation this year adding to inflationary pressures. The 2023 budget was prepared under the assumption of a significantly better macroeconomic environment and that energy prices would remain high and require significant subsidies. This would have added to other spending pressures—defense and refugees—without commensurate revenue measures. The budget has conservative assumptions on revenues and recent developments, particularly in the energy market, suggest that a sizeable amount of spending may not be executed as reflected in the updated stability plan submitted to the EU that, nevertheless reflects an already outdated macroeconomic scenario. The projected fiscal policy stance is expected to become moderately expansionary with an estimated loosening of the structural balance by 0.3 percent of potential GDP—0.9 percent of GDP under the Stability Program.

Lithuania: Fiscal Stance 2020-2023 1/

	2020	2021	2022	2023
IMF	-6.1	4.1	1.1	-0.3
Budget	-6.1	4.1	1.1	-3.7
Stability Program	-6.1	4.1	1.1	-0.9

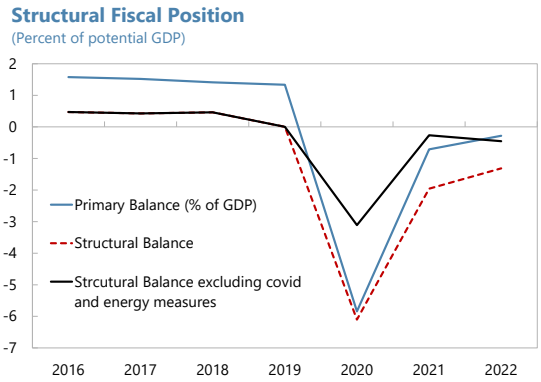
1/ Measured as the change in the structural balance in percent of potential GDP excluding new non-wage military spending in 2022 and 2023 and using IMF's macroframework.

21. To mitigate the risks of high and persistent inflation, fiscal policy should take a disinflationary stance notwithstanding a weaker economy. A small fiscal contraction this year would actively contribute to lower inflation and would have required an improvement of 0.5 percent of GDP in the structural fiscal balance. Any revenue overperformance and unnecessary spending on energy subsidies—already incorporated in our projections—should be saved in line with the Stability Program. At the same time, setting moderate minimum and public sector wages to mitigate risks of higher wage growth helps anchor inflation expectations in the private sector. The proposal by unions and businesses to increase the minimum wage by 10 percent next year stays below the current rate of inflation, but future increases will need to be prudent not to add to inflation persistence. Going forward and consistent with Lithuania's fiscal rule, a tightening of at least 0.5 percent of GDP per year over the next few years will support the disinflationary effort.

22. Accommodating new and pre-existing spending pressures will require additional revenues under the existing fiscal targets. Lithuania's spending pressures relate to negative demographics[1], one of the worst in the EU; a pension system that, while financially sustainable, unrealistically projects declining replacement ratios from already low levels; permanently higher military spending; and moderately increasing interest payments on debt. In addition, reducing high

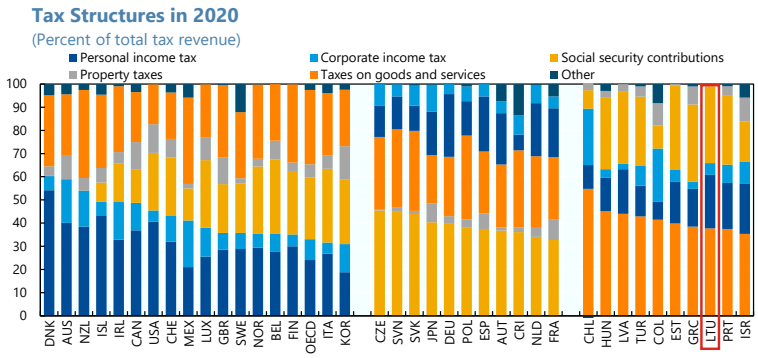
[1] The 2021 EU's ageing report projects age-related spending to increase by almost 2 percent of GDP up to 2070. Importantly, it projects small increase in pension spending due to replacement ratios falling from the current 23 percent to 13 percent in 2070, the third lowest in the EU.

poverty rates and social disparities, especially at the regional level, will require more and better social programs—currently pension spending is the main redistributive fiscal tool. With social protection spending below the EU average and discretionary spending low, accommodating additional expenditures will require revenue-generating tax reforms and/or a moderate relaxation of fiscal targets (see below). Importantly, given the transitory (energy subsidies) and targeted (pandemic measures) nature of most support measures since 2020, the structural fiscal position has remained strong.



Sources: Ministry of Finance; and IMF staff calculations.

23. Rebalancing the tax system from labor towards wealth, capital, and environmental taxes can generate more revenue and improve efficiency (Annex II). The authorities' recent tax reform proposals are a step in the right direction (Annex VII). However, these measures will only generate a modest 0.35 percent of GDP in additional net revenues. Existing environmental taxes are not enough to achieve the country's strategy for climate change mitigation and green growth. This will likely require the introduction of an economy-wide carbon tax—set to gradually increase to USD50 (or about EUR60) per metric ton of CO_2 emissions on all types of fossil fuel by 2030—that could also help lower labor taxes and increase public investment (see Box 2). There is also scope to generate revenues by removing inefficient tax concessions and exemptions—amounting to about 4.2 percent of GDP as of 2022 of which half are on the income tax and a sixth on the VAT.



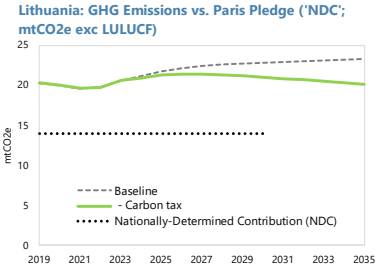
Source: OECD Revenue Statistics 2021.

Box 2. Climate Policies

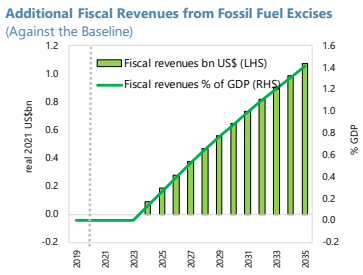
The EU plans to extend the Emissions Trading System (ETS) will effectively impose a carbon tax on a larger share of the Lithuanian economy but will not be an economy-wide measure that is necessary to achieve the country's target by 2030. Changing the energy matrix and further improving energy efficiency could bring a significant reduction in CO_2 emissions and help strengthen the country's energy security. The current pace of CO_2 emissions reductions has been slower than the EU average, largely because of the continuing increase in emissions in agriculture, transportation, services, and buildings.

Box 2. Climate Policies (concluded)

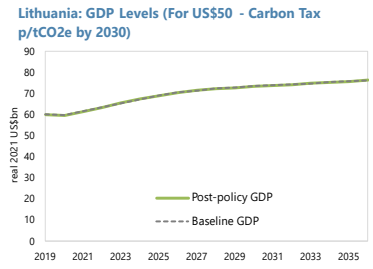
Increasing the share of renewable energy and improving efficiency could contribute to a significant reduction in emissions and imported energy. The government has ambitious plans—mostly offshore wind, and solar—and aims to reach 9GW of capacity by 2030, matching domestic demand. The introduction of an economy-wide carbon tax—set to gradually increase to at least USD50 (or about EUR60) per metric ton of CO_2 emissions on all types of fossil fuel by 2030—would be consistent with the ETS (and the recent introduction of a carbon component in excise taxes in Lithuania) and help move towards the emission reduction target and generate additional tax revenue (IMF WP No. 22/174).



Source: Climate Policy Assessment Tool, IMF.



Source: Climate Policy Assessment Tool, IMF.



Source: Climate Policy Assessment Tool, IMF.

24. The current discussion on the modification of the EU fiscal framework provides an opportunity to finetune Lithuania's domestic fiscal rule. The fiscal rule sets tighter targets—a structural surplus—than required by the EU framework. However, it is overly complex—covered by two laws with overlapping overall and structural targets and many escape clauses that effectively weaken the expenditure correction mechanism (IMF 18/186). This has delivered ample fiscal space to respond to shocks, as reflected since 2020. However, the domestic fiscal rule could be finetuned to make it simpler and accommodate some structural spending pressures, such as the permanent increase in defense. Any modification should preserve the current strong counter-cyclical stance and ample fiscal buffers—low deficits and debt—needed in a small open economy in a monetary union.

Financial Policies

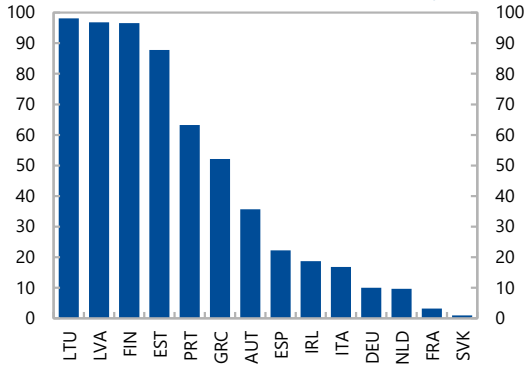
25. Higher interest margins and a cost-efficient business models have boosted profitability in the banking sector. Depositors' behavior—driven mainly by forced and precautionary savings during the pandemic and the war, and the lack of domestic investment opportunities other than real estate—shows little sensitivity to deposit rates. Thus, while interest rates on new loans have been passed through in line with the eurozone or faster (particularly for new mortgages), deposit rates have adjusted at a slower pace. The resulting increase in interest margins, traditionally in line with or below the eurozone average, has boosted short-term profitability of banks.

26. Given the high profitability of the banking system, the authorities have introduced a temporary windfall levy on banks. Efficiency, rather than the high level of concentration, has traditionally explained the higher profitability of Lithuania's banking system relative to European

banks—a poor benchmark given their post-GFC sharp fall in profitability (see Annex V). In the current environment profitability will reach unprecedented levels. The new levy will be applied this year and next to all credit institutions and existing loans—new loans are excluded—to limit the increase in net interest income to, at most, 15 percent above last year's level. The so-called "solidarity contribution" of 60 percent is applied on the net interest income that exceeds the average of the previous four years by more than 50 percent. Given the composition of the banking system, this levy mostly affects foreign banks. The proceeds, expected to be around EUR400 million, will finance military spending. This adds to what was initially planned to be a temporary increase in the corporate tax rate for big banks—again affecting mostly foreign banks—from 15 to 20 percent introduced in 2019 and made permanent last year. Thus, it will be important that the levy remains temporary to avoid being perceived as a tax on foreign investment and to minimize the potential negative impact on efficiency.

27. Higher interest rates bring significant—if manageable—non-systemic risks to the financial sector. The authorities have proactively taken appropriate macroprudential actions to address risks particularly from the real estate market due to higher interest rates—such as affordability requirements to higher interest rates for new mortgages since 2015 (see text table). The correction of property prices comes with risks given its potential impact on aggregate demand (as households cut back on consumption) and banks. However, balance sheet risks from higher interest rates and weaker activity are contained with large capital buffers and profitability able to absorb potential losses from a likely deterioration of the lending portfolio.[2] In terms of banks' securities portfolios, securities held to maturity only represent 5 percent of total assets or 60 percent of equity, making potential unrealized losses manageable.

Euro Area: Share of Mortgages with Interest Rate Fixation of less than One Year (Percent of total loans for house purchase)



Sources: ECB; Eurostat; Haver Analytics; and IMF staff calculations.

Lithuania: Macroprudential Measures

Down payment	
	15 percent first loan
	30 percent subsequent loans (introduced in 2022)
DTI	
	40 percent
	50 percent under 5 percent interest rate scenario since 2015
Maturity	
	Maximum 30 years
Systemically Important Institution buffer	
	Swedbank 2 percent
	SEB 2 percent
	Šiaulių and Revolut (since mid-2023) 1 percent
Counter-cyclical capital buffer	
	1 percent effective October 2023
Capital conservation buffer	
	2.5 percent
Sectoral systemic risk buffer	
	2 percent applicable to housing loan portfolio since July 2022

28. While ample buffers position the financial system to withstand shocks, vulnerabilities will require close monitoring. Vulnerabilities could emerge if additional shocks results in even higher interest rates and weaker activity than under the baseline. Banks are building further resilience by not fully distributing 2022 profits in order to strengthen capital. If a sharp downturn

[2] Under BoL's severe downside scenario with cumulative GDP losses of around 10 percent in three years, banks capital would still exceed minimum requirements with all banks meeting regulatory requirements. Regarding liquidity, banks are currently able to cover a 40 percent decrease in deposits.

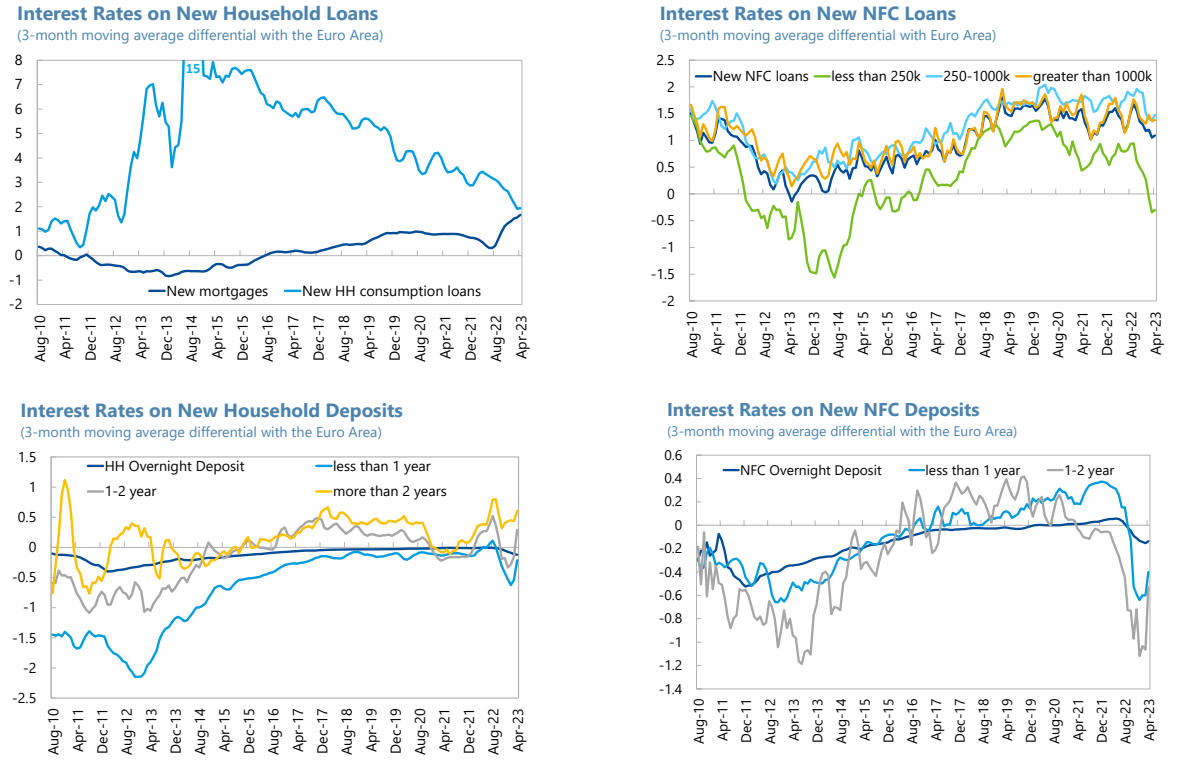
causes credit supply disruptions or a disorderly correction of real estate prices, a relaxation of capital- and borrow-based macroprudential measures should be considered.

29. Lithuania's AML/CFT framework should be further reinforced to address ML/TF risks from cross-border and non-resident financial activity. The value and volume of cross border financial flows have remained elevated since 2020, including with higher risk jurisdictions, driven in part by the BoL's enabling foreign EMI and PI to use its payment system for SEPA payments directly, heightening the ML/TF risk (see Figure 7). The number of fintechs in Lithuania has stabilized (265 in 2021 to 263 in 2022) after seven years of significant growth. Staff have been engaging with the central bank on AML/CFT recommendations issued as part of the 2022 Article IV consultation and ongoing regional Nordic-Baltic AML/CFT technical assistance project to support it to address the ML/TF risks faced in the fintech sector and by the country's cross-border and non-resident activity.

Select AML/CFT Recommendations from 2022 AIV Consultation and Ongoing Regional Nordic-Baltic AML/CFT Technical Assistance Project

Cross-border and Non-Resident ML/TF Risk Understanding	• Expand the National Risk Assessment to cover Analysis of ML/TF Risks from non-resident activity and cross-border payments and reflect the evolution of the financial sector. • Develop and operationalize understanding of ML/TF higher-risk countries based on Lithuania-specific risk factors in coordination with all relevant AML/CFT agencies. • Monitor the rapid and sizable increase in the value and volume of correspondent banking transactions from an ML/TF perspective
AML/CFT Supervision of Banks and Virtual Asset Service Provider	• Broaden the AML/CFT supervisory coverage of the financial sector with a focus on risk-sensitive supervisory presence in the sector and a more detailed strategy for the risk-based supervision of banks • Strengthen BOL's AML/CFT resources and capacity • Increase AML/CFT controls to access the BoL payment system (CENTROlink), including formalizing risk rating methodology to inform CENTROlink onboarding decisions. • Strengthen ongoing monitoring of PSP activity in CENTROlink and fine-tune BoL's due diligence questionnaire to reflect Lithuania-specific ML/TF risks

Impact of Higher Interest Rates on Deposit and Lending Rates



Source: European Central Bank; Haver Analytics; and IMF staff calculations.

Authorities' Views

30. The authorities emphasize that fiscal policy should contribute to macroeconomic stabilization and note that price stability is not its only objective. They are committed to save any revenue overperformance and savings from lower-than-budgeted energy subsidies in 2023. They consider that the broadly neutral fiscal stance this year and the gradual pace of fiscal adjustment going forward, strikes a balance between facilitating disinflation and supporting economic activity. They reiterate their commitment to prudent fiscal policy as reflected in the domestic fiscal rule that is set to become operational again next year. They also highlight that the proposed tax reform will make the system more fair and efficient, as well as support economic growth and underline that the approved changes in excises, including the increase of rates on fossil fuels and the introduction of a carbon component, will support the green transition.

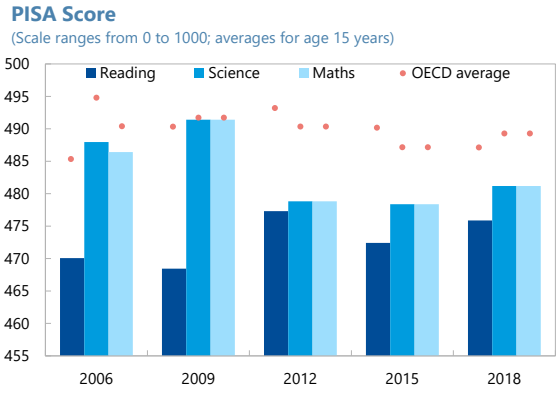
31. The authorities emphasize that ample buffers in the banking sector provide stability and they have taken important steps in addressing risks from the maturing fintech sector. They stress that macroprudential actions have increased buffers and that risks from the real estate market are receding with the gradual decrease of housing price overvaluation. They emphasize that the solidarity contribution on banks is temporary and has been designed to avoid distortions and negative effects on financial stability. They stress that given unprecedented profitability, post-contribution profits will remain elevated so as to allow building further resilience if needed. They reiterate their determination to address risks associated with the fintech sector and highlight the decisive actions taken to increase supervisory resources and strengthen the regulatory framework including for virtual asset service providers (VASPs). They plan to continue enhancing the domestic AML/CFT framework.

B. Structural Reforms: Unlocking Growth Potential

32. Lithuania has outperformed its peers since the GFC, but structural reforms will be key to mitigate possible scarring from recent shocks and accelerate further income convergence. The balanced high-productivity growth path since the GFC has supported rapid wage growth. To further improve productivity it is critical to implement key structural reforms that enhance private sector-led growth and mitigate or reverse negative demographic dynamics.

33. The structural flexibility of the economy, particularly of the labor market, remains a key factor to absorb shocks and mitigate their impact. In the past, wages and productivity have been closely linked and temporary deviations have been self-corrected (see Annex V). The 2017 labor code reform introducing new labor contracts and reducing severance payments, increased flexibility further in what was an already flexible labor market. At the same time, it increased the benefits and duration of the unemployment insurance enhancing the social safety net. In this context, moderate increases in the minimum wage can contribute to fight inflation. In any case, the targeted range—45-50 percent of average wages—disproportionately affects low-skilled and young workers in rural areas whose wages are well below the national average reflecting lower productivity. The recently approved civil sector reform aims at increasing accountability, flexibility, and efficiency in the public sector.

34. Given poor outcomes in education and health, reforms in these areas, while politically difficult, are critical to support productivity and address disparities. On healthcare, expenditure is broadly in line with peers but the share of out-of-pocket spending is 15 percentage points higher, suggesting a significant burden on patients that, nevertheless, face the lowest life expectancy in the EU. On education, PISA scores are significantly below the OECD average. Spending on primary and secondary education is the lowest of the OECD with large inefficiencies focused on maintaining an overgrown network that does not reflect demographic trends. Finally, tertiary education outcomes do not align well with labor market needs resulting in some graduates needing vocational training to join the labor market and the third largest level of skills mismatch in the EU.



Source: Program for International Student Assessment (PISA), OECD.

35. Improving energy efficiency and strengthening energy security remain important priorities. The new energy matrix and the transition towards it—there are ambitious plans to increase the share of renewables from the current 30 percent to 50 percent by 2030—should be carefully calibrated to avoid hampering long-term growth. Moving away from fossil fuels and increasing energy efficiency are necessary to enhance energy security and reduce CO_2 emissions in line with the country's pledges for climate change mitigation.[3] The current pace of reduction in emissions is not consistent with that objective. To this end, introducing an economy-wide carbon tax and other measures including "feebates" on fossil-fuel consumption would incentivize energy conservation, more investment in renewable energy, and raise additional fiscal revenues.

Authorities' Views

36. The authorities are committed to structural reforms to unlock the country's growth potential and address risks associated with climate change. They continue to pursue reforms in education and healthcare as well as innovation and green transition. They highlighted the approval of civil sector reform that will provide greater accountability and flexibility in the public sector enhancing productivity. The green transition and energy independence remain top priorities with the ambitious goal of renewables generating 100 percent of electricity demand by 2030.

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37. The Lithuanian economy remained resilient until the end of last year. High inflation and rising interest rates weakened disposable income which, combined with weak external demand, resulted in an economic contraction. Lower energy prices are helping decrease inflation, that

[3] S. Cevik (2022), "Climate Change and Energy Security: The Dilemma or Opportunity of the Century?" IMF Working Paper No. 22/174 (Washington, DC: International Monetary Fund).

remains significantly above the eurozone average. A recovery is expected later this year. Risks are tilted to the downside with persistently higher inflation than the euro area as the biggest risk.

38. Fiscal policy is projected to become moderately expansionary this year adding to inflationary pressures. To mitigate the risk of high and persistent inflation and notwithstanding weaker activity, a fiscal contraction would actively contribute to lower inflation. Going forward, the contractionary fiscal stance resulting from the reactivation of the domestic fiscal rule will help contain inflation risks.

39. Accommodating new and pre-existing spending pressures will likely require new revenues under the existing fiscal targets. At the same time and in the context of the discussions to modify the EU fiscal framework, the domestic fiscal rule can be simplified and adjusted to accommodate permanently higher defense spending. In any case, any modification should preserve ample fiscal buffers necessary to ensure an effective counter-cyclical stance.

40. Rebalancing the tax system from labor towards wealth, capital, and environmental taxes can generate additional revenue and improve efficiency. The recent reform of excise taxes adding an environmental component will not be enough to achieve the country's strategy for climate change. Other tax proposals aim at improving efficiency and equity will largely reverse revenue gains from the increase in excises. These reforms are a step in the right direction but neither go far enough in rebalancing the tax system nor will they generate much additional revenue.

41. A weakening economy and higher interest rates bring risks to the banking sector but should remain manageable given high liquidity, capitalization, and profitability. The correction in property prices is bringing valuations closer to fundamentals in an orderly fashion so far. The negative impact of higher interest rates and weaker activity should be contained given large capital buffers and profitability. However, vulnerabilities will require close monitoring, especially if additional shocks result in even higher interest rates and weaker economic activity. A sharp downturn could cause credit supply disruptions or a disorderly correction in the real estate market. In such a scenario, the BoL should consider a relaxation of capital-based macroprudential and, potentially, borrower-based measures.

42. The levy on banks should remain temporary to avoid being perceived as a tax on foreign investment and minimize the potential negative impact on efficiency. While the levy has been carefully designed to avoid disincentivizing lending in the short-run, permanent sector-specific taxes on excess profits have a distortionary impact over time. Furthermore, in the current environment, preserving financial stability is a key priority. Frequent ad hoc tax changes in sectors with significant foreign investment risk weakening Lithuania's hard-fought reputation as a stable, predictable, and competitive tax destination.

43. There has been progress in addressing money laundering and terrorist financing (ML/FT) risks in the financial sector responding to the challenges from the fintech sector. Steps have been taken including increasing ML/TF supervisory resources and on risk assessment of new and existing clients of BoL's payments system (CENTROLink). Progress has also been made in

the VASP sector by upgrading the regulatory framework and introducing a sectoral risk assessment. Going forward emphasis should be placed on supporting risk-based supervision and increasing supervisory powers and market entry controls. Regarding the wider AML/CFT framework, some deficiencies identified in the country's 2018 MONEYVAL Mutual Evaluation report have been addressed. However, further progress is needed on mitigating remaining risks in the VASP sector and on regulation and supervision of designated non-financial businesses and professions, through the passing of the draft amendments to the AML/CFT law.

44. Lithuania's external position was substantially weaker than fundamentals in 2022 (Annex III). As the deterioration of the current account is largely temporary, it is expected to converge over time to its norm under the current baseline.

45. Preserving the flexibility of the economy and advancing long-overdue structural reforms will be needed to support further productivity gains and higher living standards. The recently approved civil service reform aimed at increasing flexibility, efficiency and accountability in the public sector is a step in the right direction. At the same time, it is critical to accelerate ongoing reforms in education and healthcare.

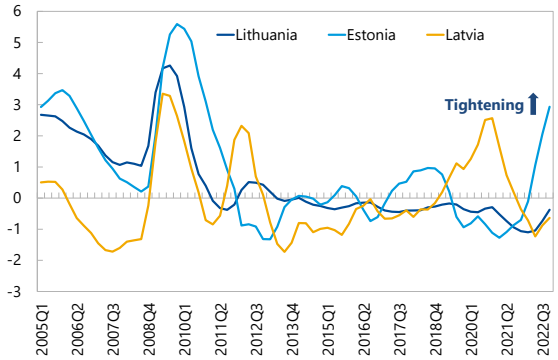
46. Developing renewable sources of energy and improving energy efficiency are necessary for climate change mitigation and energy security. The new energy matrix and the transition towards it should be carefully calibrated to avoid hampering long-term growth. Meeting Lithuania's pledges for climate change mitigation will require the application of a carbon tax in sectors not covered by the ETS and other measures including "feebates".

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

Figure 1: Lithuania: Inflation Developments

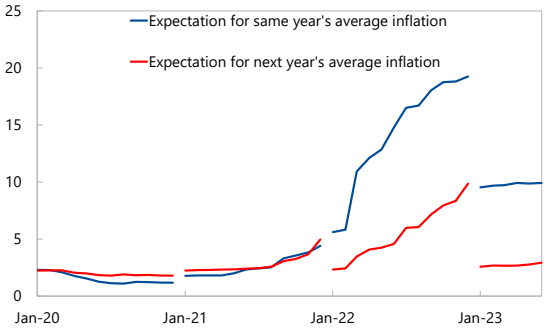
Monetary conditions have tightened but remain looser than warranted.

Financial Conditions Index
(Index)



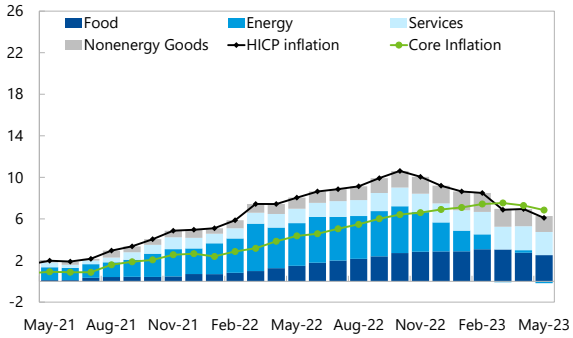
Inflation expectations increased along with the burst of inflation in 2022 but are not de-anchored.

Survey Based Inflation Expectations
(Percent)



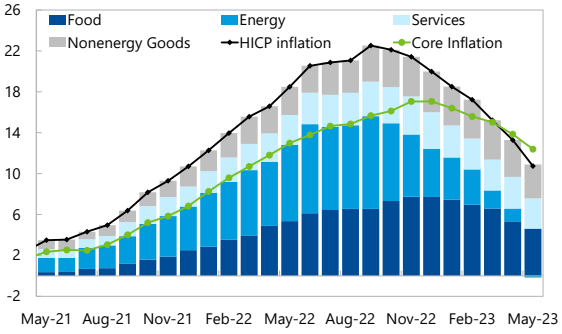
After the decline in energy prices inflation in the euro area now mainly reflects food and services prices…

Euro Area: Inflation Decomposition
(Percentage points)



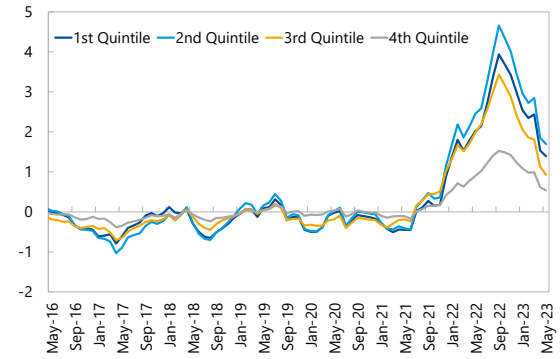
… but it remains more broad-based in Lithuania.

Lithuania: Inflation Decomposition
(Percentage points)



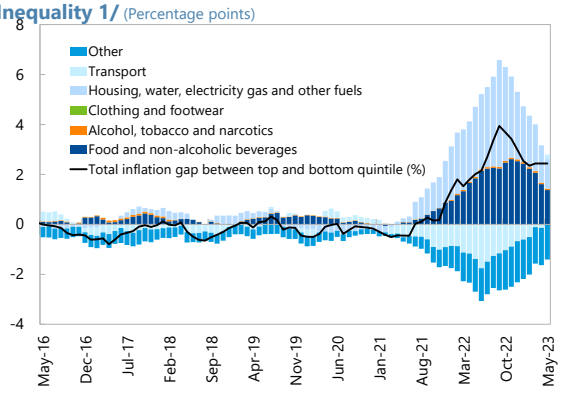
Spending on energy and food is higher than in the euro area…

Inflation Gap Relative to 5th Quintile
(Percentage points)



… reinforcing the impact on low-income households who spend more on energy and food.

Contribution of Consumption Categories to Inflation Inequality 1/ (Percentage points)

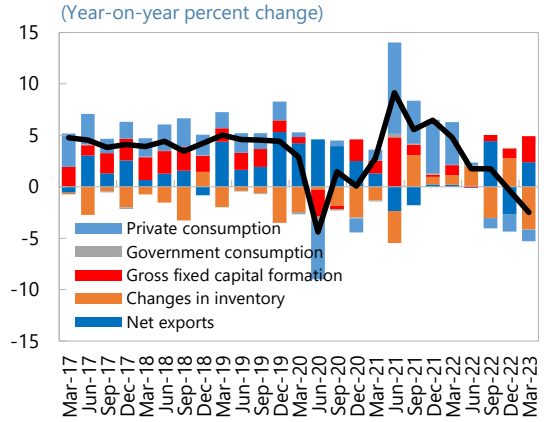


Sources: European Central Bank; Consensus Forecast; Eurostat; IMF; and IMF staff calculations.
1/ Measured as the gap between top and bottom quintile for each consumption category.

Figure 2: Lithuania: Macroeconomic Developments

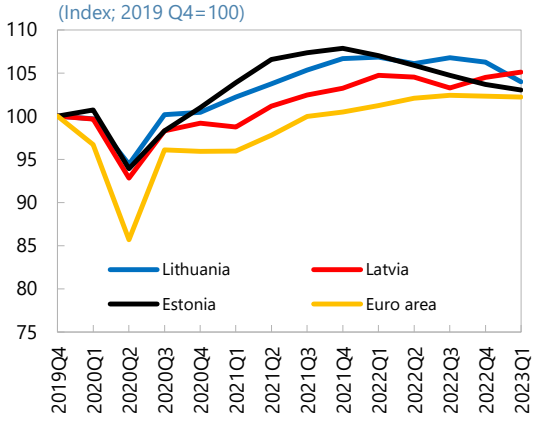
Lithuania was on a strong recovery path but started to show signs of weakening in the last two quarters...

Real GDP growth and Components Contribution
(Year-on-year percent change)



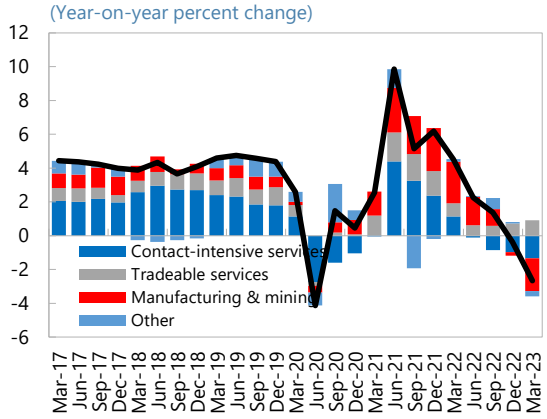
... but still outpacing most euro area peers.

Quarterly Real GDP
(Index; 2019 Q4=100)



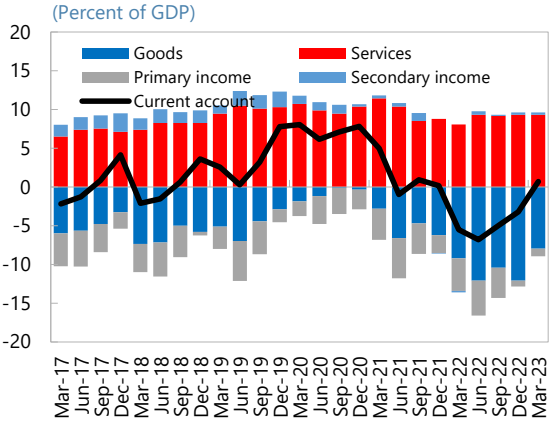
Activities started to weaken in the second half of 2022, but tradable services remain resilient...

Contributions to GDP Growth by Industry
(Year-on-year percent change)



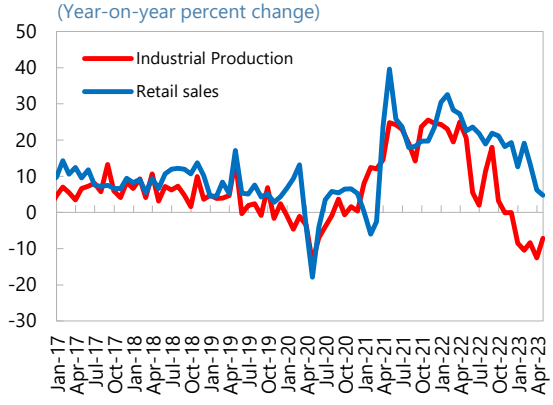
... accompanied by a declining trade surplus related to weakening external demand.

Current Account Balance
(Percent of GDP)



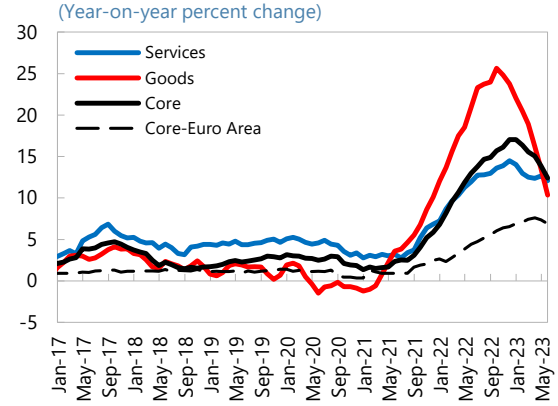
Industrial production started to decrease since the second half of 2022

Industrial Production and Retail Sales
(Year-on-year percent change)



... while inflation slows down but remains higher than the Euro area average.

HICP Inflation
(Year-on-year percent change)

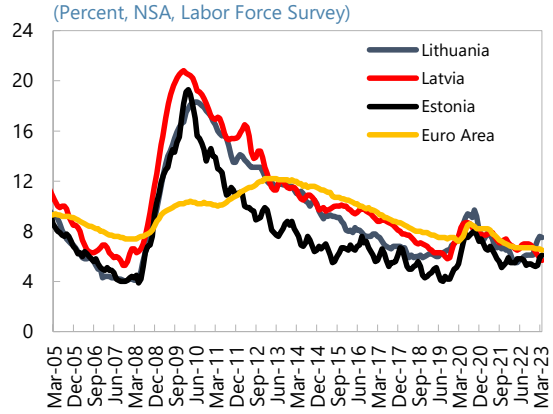


Sources: Haver Analytics; Statistics Lithuania; Bank of Lithuania; and IMF staff calculations.

Figure 3: Lithuania: Labor Market Developments

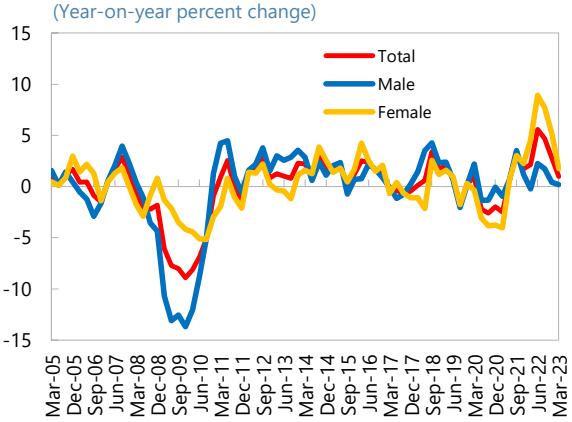
With sustained growth until the last quarter of 2022, unemployment remained on a downward path…

Unemployment Rate
(Percent, NSA, Labor Force Survey)



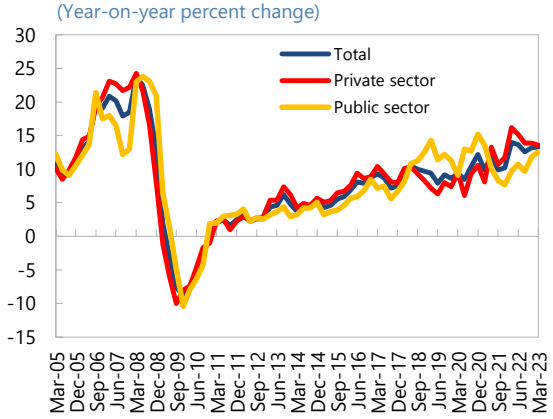
… while employment growth accelerated.

Employment Growth
(Year-on-year percent change)



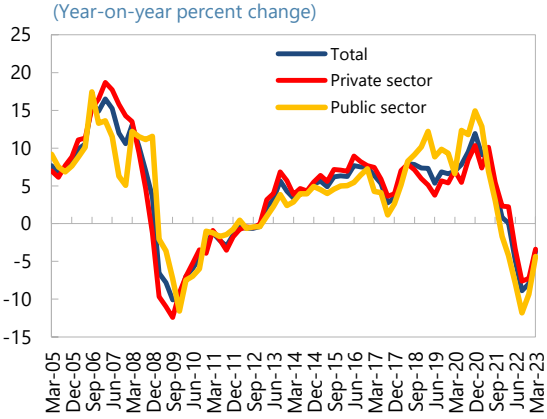
Wage growth has been strong for a few years now…

Nominal Wage Growth
(Year-on-year percent change)



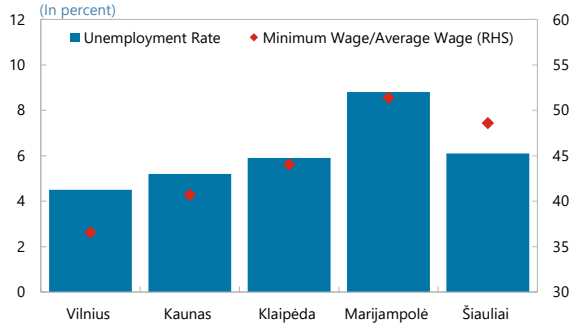
… but real wages have been negative with high inflation.

Real Wage Growth
(Year-on-year percent change)



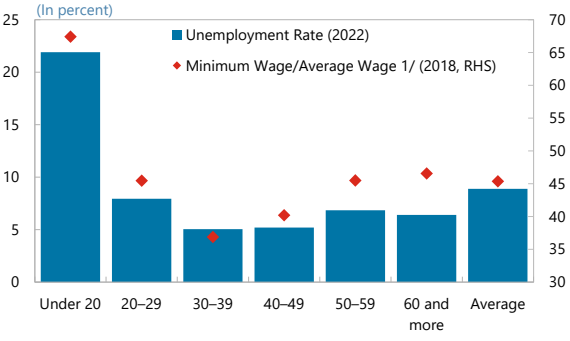
A high minimum wage disproportionately affects rural areas…

Minimum Wage and Unemployment Rate by Region, 2022
(In percent)



…and the young

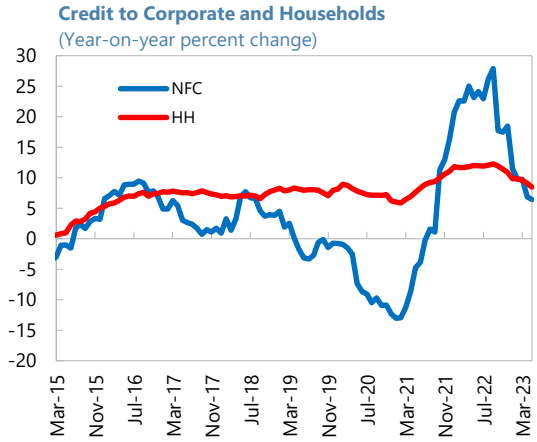
Minimum Wage and Unemployment Rate by Age Group
(In percent)



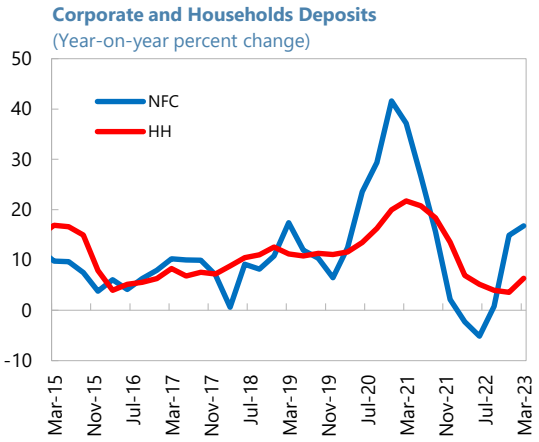
Sources: Haver Analytics; Eurostat; Statistics Lithuania; and IMF staff calculations.
1/ Based on the structure of earnings indicators released every four years.

Figure 4: Lithuania: Banking Sector Developments

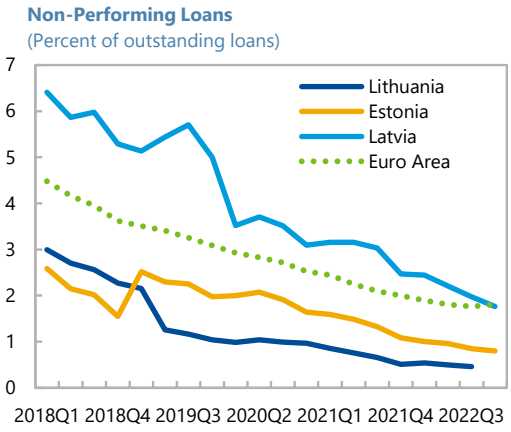
Credit growth, especially for corporates, has decelerated with tightening monetary conditions.



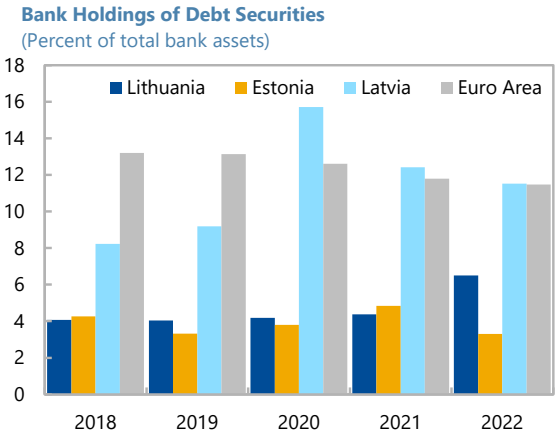
Deposits appear to have stabilized after large increases during 2020 and 2021.



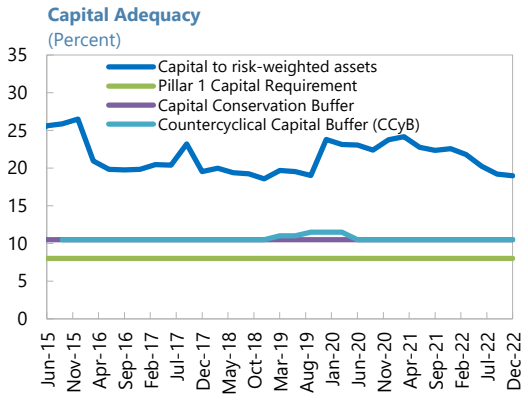
The resilient economy and strong household and corporate balance sheets have led to low NPLs.



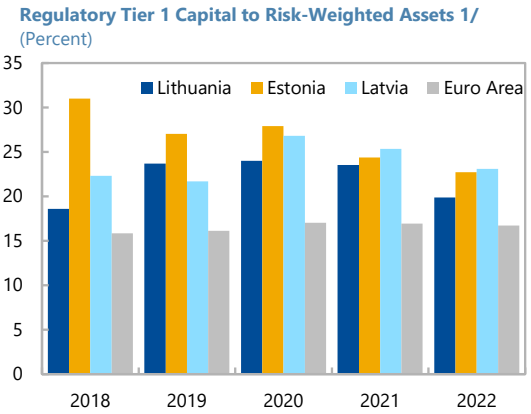
Banks holdings of securities are low…



… and they continue to have significant capital buffers…



..largely in the form of Tier 1 Capital.

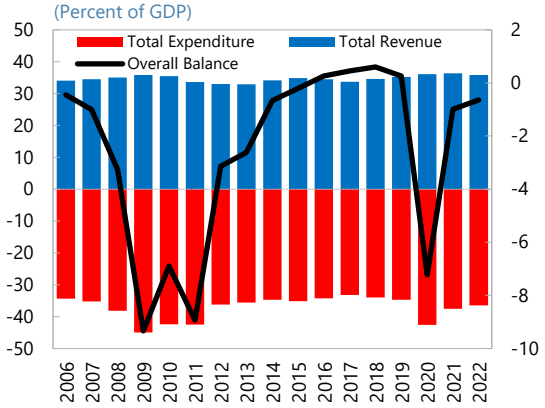


Sources: Bank of Lithuania; BIS; European Central Bank; Haver Analytics; and IMF staff calculations.
1/ Data for Lithuania is as of 2022Q3.

Figure 5: Lithuania: Fiscal Developments

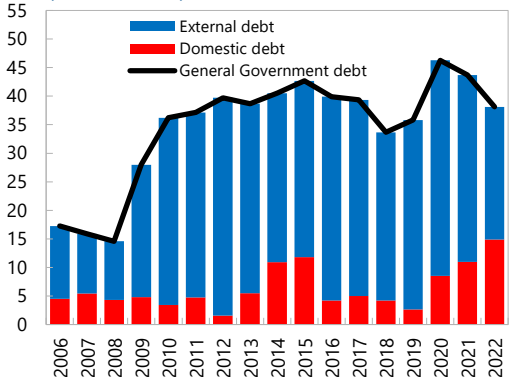
Strong revenue growth and lower (pandemic-related) spending narrowed the budget deficit.

General Government Total Revenue and Expenditure
(Percent of GDP)



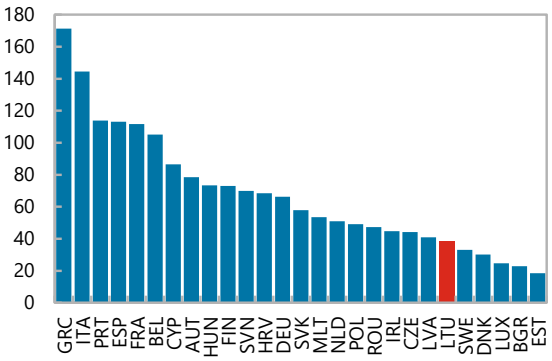
Better fiscal performance and higher nominal GDP growth lowered the debt-to-GDP ratio.

General Government Debt
(Percent of GDP)



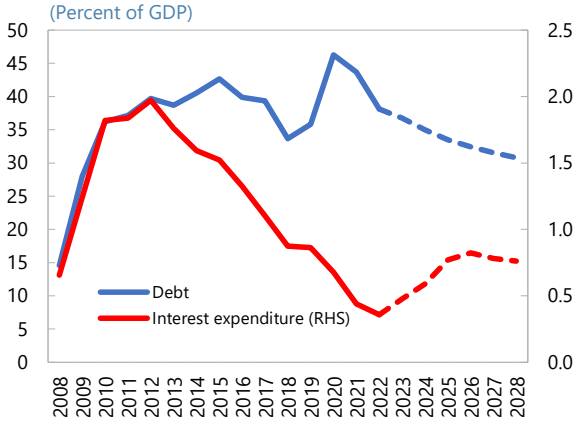
Lithuania's government debt is among the lowest in the region.

General Government Debt, 2022
(Percent of GDP)



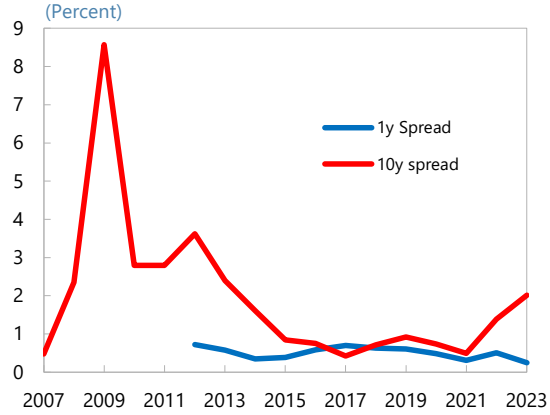
The interest bill is projected to remain low, thanks partly to the decline in government debt...

Debt and Interest Expenditure
(Percent of GDP)



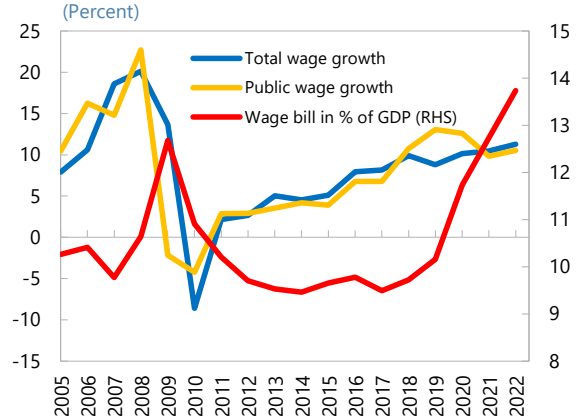
... and partly because of Lithuania's improving credit quality as measured by bond spreads.

1-year and 10-year Spread over Germany
(Percent)



Wage growth is key to inflation and competitiveness, and the public sector will play a critical role.

Nominal Wage Growth vs. Wage Bill
(Percent)

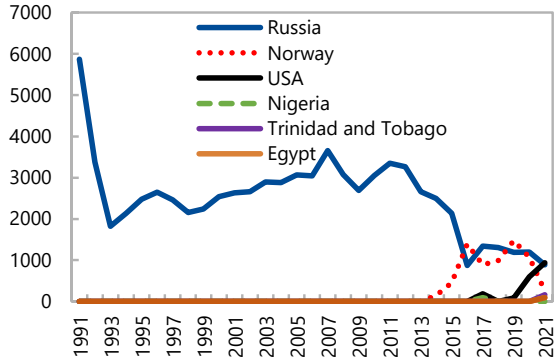


Sources: Ministry of Finance; Statistics Lithuania; Haver Analytics; and IMF staff calculations.

Figure 6: Lithuania: Energy Imports by Partner Countries, 1991–2021

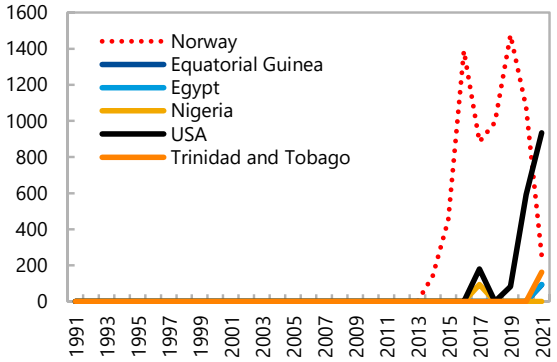
Efforts to diversify away from Russian gas started after Russia's annexation of Crimea...

Imports of Natural Gas
(Million cubic metres)



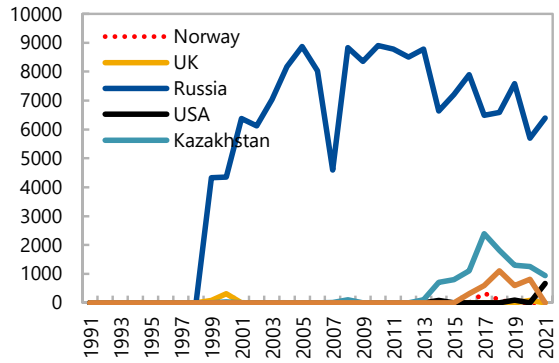
... replacing it with liquified gas from Norway and the United States.

o/w Imports of LNG
(Million cubic meters)



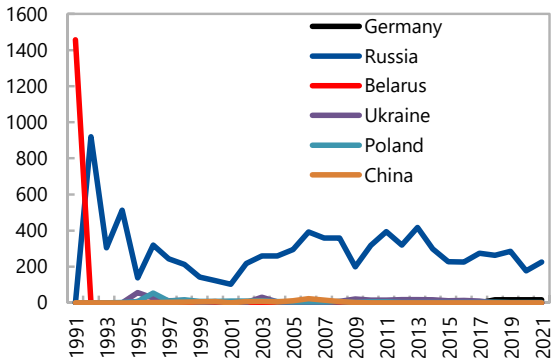
Diversification of crude oil and solid fuels have been more limited...

Imports of Crude Oil
(Thousand tonnes)



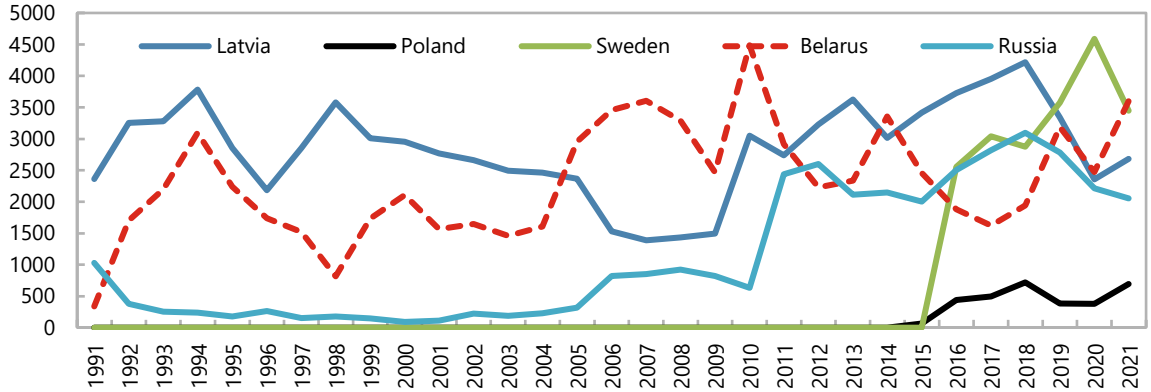
... as they are global markets.

Imports of Solid Fuels
(Thousand tonnes)



Electricity imports from Russia and Belarus remained large, albeit gained access to the European network has allowed for a prompt decline in dependency.

Imports of Electricity
(Gigawatt-hours)

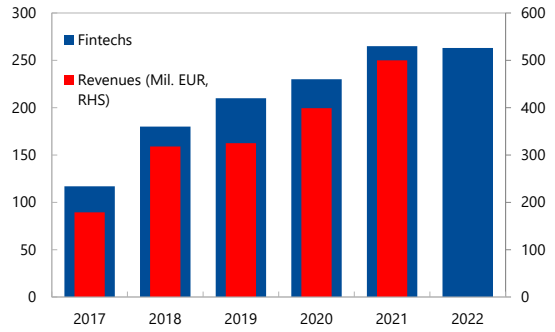


Sources: Eurostat; and IMF staff calculations.

Figure 7: Lithuania: Evolving ML/FT Threats

The success in attracting Fintech to Lithuania has led to a significant increase in non-resident cross-border activity…

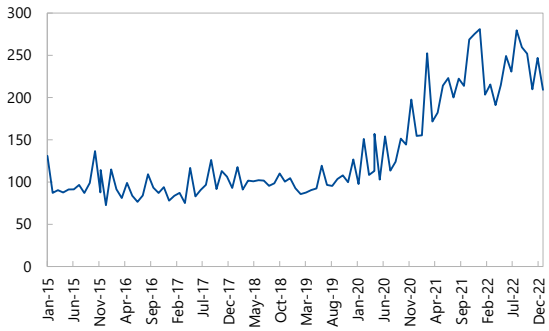
Fintechs in Lithuania



… with a large rise in cross-border flows in the last few years…

Gross Cross-Border Flows

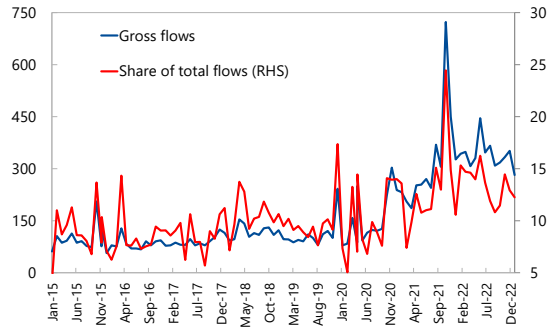
(Index, 2015=100)



…particularly to financial centers.

Gross Flows to Financial Centers

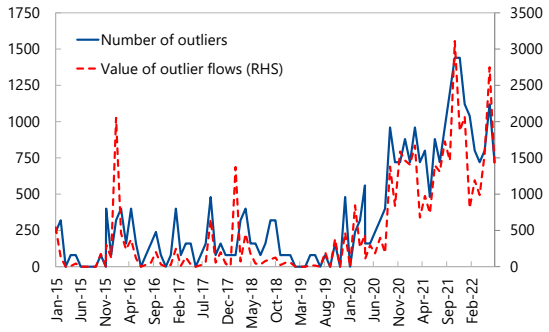
(Flows index, 2015=100; share in percent)



Outliers among outflows have intensified exponentially…

Outflows Outliers

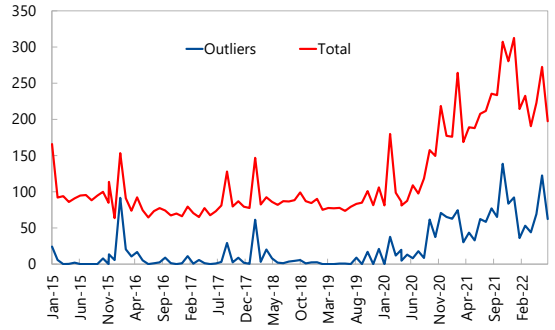
(Index, 2015=100)



… accounting for a large share of the increase in outflows

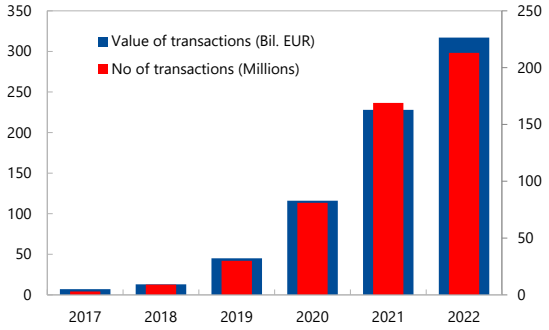
Outflows Outliers vs Non-Outliers

(Outlows index, 2015=100)



CENTROlink fostered these flows, and its controls are key to safeguard the European payment system integrity.

E-money and Payment Institutions Transactions through CENTROlink



Sources: Invest Lithuania, 2022; Swift; and IMF staff calculations.

Table 1: Lithuania: Selected Economic Indicators, 2018–28

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
						Projections					
Output											
Real GDP growth (annual percentage change)	4.0	4.6	0.0	6.0	1.9	-1.4	2.9	2.7	2.5	2.2	2.1
Domestic demand (contribution to growth)	3.3	1.3	-3.8	6.7	1.3	-1.1	2.7	2.6	2.3	2.1	1.9
Domestic demand growth (year-on-year, in percent)	3.4	1.5	-3.8	7.0	1.6	-1.2	2.9	2.8	2.5	2.2	2.1
Private consumption growth (year-on-year, in percent)	3.6	2.7	-2.5	8.0	0.5	-0.4	2.9	2.8	2.5	2.2	2.0
Domestic fixed investment growth (year-on-year, in percent)	10.0	6.6	-0.2	7.8	2.6	3.0	3.7	3.5	3.2	3.0	2.8
Inventories (contribution to growth)	-1.1	-1.6	-1.9	0.0	0.6	-1.8	0.0	0.0	0.0	0.0	0.0
Net external demand (contribution to growth)	0.7	3.3	3.8	-0.7	0.6	-0.2	0.2	0.2	0.2	0.2	0.2
Export growth (year-on-year, in percent)	6.8	10.1	0.4	17.0	11.9	-1.7	4.6	4.8	5.0	5.1	5.0
Import growth (year-on-year, in percent)	6.0	6.0	-4.5	19.9	12.3	-1.6	4.7	5.0	5.3	5.3	5.1
Nominal GDP (in billions of euro)	45.5	48.9	49.8	56.2	66.8	72.1	77.9	83.0	87.6	91.8	96.0
Potential GDP growth	3.6	3.7	2.3	2.6	2.2	1.5	2.5	2.4	2.2	2.2	2.2
Output gap (percent of potential GDP)	0.2	1.2	-1.1	2.2	1.9	-1.1	-0.7	-0.3	0.0	0.0	0.0
Employment											
Employment (annual percentage change)	1.5	0.3	-1.5	0.8	3.8	-2.8	0.2	0.1	0.1	-0.1	-0.1
Unemployment rate (year average, in percent of labor force)	6.1	6.3	8.5	7.1	5.9	7.8	6.7	6.2	6.0	6.0	6.0
Average monthly gross earnings (annual percentage change) 1/	9.9	8.8	10.1	10.5	11.3	11.9	8.5	6.2	5.0	5.1	5.1
Average monthly gross earnings, real (annual percentage	7.2	6.4	9.0	5.6	-6.4	2.3	4.5	3.3	2.4	2.6	2.6
Labor productivity (annual percentage change)	2.5	4.3	1.5	5.2	-1.9	1.5	2.7	2.6	2.4	2.3	2.2
Prices											
HICP, period average (annual percentage change)	2.5	2.2	1.1	4.6	18.9	9.6	4.0	3.0	2.6	2.5	2.4
HICP core, period average (annual percentage change)	2.1	2.5	2.5	3.2	13.6	10.8	4.7	3.2	2.6	2.5	2.4
HICP, end of period (year-on-year percentage change)	1.8	2.7	-0.1	10.7	20.0	4.1	3.0	2.9	2.5	2.5	2.5
GDP deflator (year-on-year percentage change)	3.5	2.7	1.9	6.3	16.7	9.4	5.0	3.8	2.9	2.5	2.4
General Government Finances											
Revenue (percent of GDP)	34.5	35.2	36.1	36.4	35.8	38.1	36.7	36.1	35.5	35.6	35.5
Of which EU grants	0.7	0.9	0.7	0.6	0.7	1.1	0.4	0.5	0.3	0.3	0.3
Expenditure (percent of GDP)	34.0	34.7	42.6	37.5	36.5	40.1	38.2	37.3	36.7	36.6	36.5
Of which: Non-interest	33.1	33.9	41.9	37.1	36.1	39.6	37.6	36.5	35.9	35.8	35.7
Interest	0.9	0.9	0.7	0.4	0.4	0.5	0.6	0.8	0.8	0.8	0.8
Fiscal balance (percent of GDP)	0.5	0.5	-6.5	-1.2	-0.6	-2.0	-1.5	-1.2	-1.1	-1.0	-1.0
Fiscal balance excl. one-offs (percent of GDP)	0.5	0.4	-6.6	-1.2	-0.6	-2.0	-1.5	-1.2	-1.1	-1.0	-1.0
Structural fiscal balance (percent of potential GDP) 2/	0.5	0.0	-6.1	-2.0	-1.3	-1.6	-1.2	-1.0	-1.1	-1.0	-1.0
General government gross debt (percent of GDP)	33.7	35.8	46.3	43.7	38.1	36.7	35.0	33.5	32.4	31.5	30.8
Of which: Foreign currency-denominated	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance of Payments (in percent of GDP, unless otherwise specified)											
Current account balance	0.3	3.5	7.3	1.1	-5.1	-2.2	-1.5	-1.1	-0.6	-0.2	0.8
Current account balance (billions of euros)	0.1	1.7	3.6	0.6	-3.4	-1.6	-1.1	-0.9	-0.5	-0.2	0.7
Saving-Investment Balance (in percent of GDP)											
Gross national saving	20.6	21.3	21.3	20.8	21.7	21.6	22.7	23.7	24.7	25.3	26.0
Gross national investment	20.4	17.7	14.0	19.6	26.7	23.7	24.2	24.8	25.2	25.5	25.2
Foreign net savings	-0.3	-3.5	-7.3	-1.1	5.1	2.2	1.5	1.1	0.6	0.2	-0.8

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, 2018–28

(ESA 2010 aggregates, in percent of GDP)

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
						Projections					
Statement of Operations											
Revenue	34.5	35.2	36.1	36.4	35.8	38.1	36.7	36.1	35.5	35.6	35.5
Revenue excluding EU grants	33.8	34.3	35.4	35.7	35.2	37.1	36.3	35.6	35.3	35.3	35.2
Tax revenue	17.1	20.3	20.8	21.6	21.6	21.9	21.5	21.3	21.2	21.2	21.2
Direct taxes	5.7	8.8	9.0	9.7	10.1	10.3	10.0	9.8	9.7	9.5	9.5
Personal income tax	4.0	7.0	7.1	7.4	7.7	7.7	7.6	7.5	7.5	7.4	7.3
Corporate income tax	1.5	1.6	1.6	2.1	2.4	2.4	2.3	2.3	2.2	2.1	2.1
Other	0.1	0.2	0.4	0.1	0.0	0.2	0.2	0.0	0.0	0.0	0.0
Indirect taxes	11.5	11.5	11.8	11.9	11.6	11.5	11.4	11.5	11.5	11.7	11.7
VAT	7.7	7.9	8.0	8.3	8.5	8.5	8.3	8.2	8.2	8.2	8.2
Excises	3.2	3.0	3.1	3.0	2.5	2.5	2.5	2.6	2.7	2.9	2.9
Other	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Social contributions	13.0	10.0	10.6	10.6	10.3	10.2	10.1	10.1	10.1	10.1	10.1
Grants	0.7	0.9	0.7	0.6	0.7	1.1	0.4	0.5	0.3	0.3	0.3
Other revenue	3.7	3.9	4.0	3.6	3.3	5.0	4.7	4.3	4.0	4.0	3.9
Total Expenditure	34.0	34.7	42.6	37.5	36.5	40.1	38.2	37.3	36.7	36.6	36.5
Current spending	30.8	31.5	37.9	34.3	33.4	36.0	34.3	33.9	33.3	33.2	33.1
Compensation of employees	9.7	10.1	11.2	10.7	10.2	10.3	10.3	10.3	10.3	10.3	10.3
Goods and services	4.4	4.4	4.5	4.3	4.3	5.8	5.7	5.5	5.2	5.2	5.1
Interest payments	0.9	0.9	0.7	0.4	0.4	0.5	0.6	0.8	0.8	0.8	0.8
Foreign	0.8	0.6	0.2	0.1	0.2	0.3	0.4	0.5	0.5	0.5	0.4
Domestic	0.1	0.2	0.5	0.4	0.2	0.2	0.2	0.3	0.3	0.3	0.3
Subsidies	0.4	0.4	2.4	1.6	1.7	0.8	0.3	0.3	0.3	0.3	0.3
Grants	0.8	0.8	1.1	0.9	0.7	0.9	0.7	0.6	0.6	0.6	0.6
Social benefits	13.4	13.9	16.4	15.0	14.1	15.1	14.8	14.5	14.5	14.5	14.5
Other expense	1.1	1.1	1.6	1.3	2.0	2.5	2.0	1.9	1.5	1.5	1.5
Capital spending	3.2	3.2	4.7	3.3	3.1	4.1	3.9	3.4	3.4	3.4	3.4
Overall Budget Balance	0.5	0.5	-6.5	-1.2	-0.6	-2.0	-1.5	-1.2	-1.1	-1.0	-1.0
Net acquisition of financial assets	-2.0	5.6	4.4	1.8	0.7	-0.6	-0.5	-0.5	-0.5	-0.4	-0.4
Domestic	-1.6	3.6	5.9	1.8	0.7	-0.5	-0.5	-0.5	-0.4	-0.4	-0.4
Foreign	-0.4	2.0	-1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	-2.5	5.2	11.0	2.9	1.4	1.4	1.0	0.7	0.7	0.6	0.6
Domestic	-0.1	-0.5	5.9	3.7	5.6	0.9	0.4	0.4	0.6	0.7	0.7
Foreign	-2.4	5.8	5.2	-0.8	-4.3	0.5	0.5	0.3	0.0	-0.1	-0.1
Financial Balance Sheet											
Financial assets	26.2	31.1	34.7	33.8	28.5	...	...	...	...	...	...
Currency and deposits	5.6	8.9	12.9	13.0	10.0	...	...	...	...	...	...
Securities other than shares	1.0	1.4	0.4	0.5	1.5	...	...	...	...	...	...
Loans	1.2	1.7	1.9	2.2	2.6	...	...	...	...	...	...
Shares and other equity	14.1	13.7	13.4	12.8	10.3	...	...	...	...	...	...
Other financial assets	4.2	5.4	6.1	5.3	4.1	...	...	...	...	...	...
Financial liabilities	40.7	44.5	55.2	50.6	38.2	...	...	...	...	...	...
Currency and deposits	0.4	0.4	0.2	0.2	0.0	...	...	...	...	...	...
Securities other than shares	31.4	34.7	42.0	37.0	26.7	...	...	...	...	...	...
Loans	5.0	5.1	8.0	8.4	7.1	...	...	...	...	...	...
Other liabilities	3.8	4.3	4.8	4.9	4.3	...	...	...	...	...	...
Net financial worth	-14.5	-13.4	-20.5	-16.8	-9.7	...	...	...	...	...	...
Memorandum Items:											
GDP (in millions of euros)	45,515	48,916	49,829	56,154	66,791	72,098	77,883	83,027	87,586	91,778	95,979
General government debt (Maastricht def.)	33.7	35.8	46.3	43.7	38.1	36.7	35.0	33.5	32.4	31.5	30.8
Foreign debt	29.5	33.2	37.7	32.7	23.2	22.1	21.0	19.9	18.9	18.0	17.1
Domestic debt	4.2	2.7	8.5	11.0	14.9	14.7	14.0	13.6	13.5	13.6	13.7

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, 2018–28

(Billions of Euros, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
								Projections			
Current Account Balance	0.1	1.7	3.6	0.6	-3.4	-1.6	-1.1	-0.9	-0.5	-0.2	0.7
Merchandise trade balance	-2.8	-2.3	-0.4	-2.9	-7.3	-5.6	-5.5	-5.5	-5.5	-5.7	-5.8
Exports (f.o.b.)	24.6	26.0	25.5	31.6	41.1	37.5	39.8	42.1	44.6	47.3	50.3
Imports (f.o.b.)	27.4	28.3	25.9	34.5	48.4	43.1	45.3	47.6	50.1	53.0	56.0
Services balance	3.7	5.0	5.0	5.4	6.0	5.7	6.2	6.5	6.7	6.9	7.6
Exports	9.7	11.9	10.9	13.6	17.4	15.9	16.8	17.7	18.5	19.4	20.8
Imports	6.0	6.9	5.9	8.1	11.4	10.1	10.6	11.2	11.8	12.4	13.2
Primary income balance	-1.4	-1.7	-1.4	-1.7	-2.2	-1.8	-2.1	-2.1	-1.9	-1.6	-1.4
Receipts	1.1	1.1	1.1	1.3	1.5	1.7	1.8	1.9	2.0	2.1	2.2
Payments	2.5	2.8	2.6	3.5	3.7	3.5	3.9	4.0	3.9	3.8	3.6
Secondary income balance	0.7	0.8	0.4	0.3	0.1	0.2	0.3	0.2	0.2	0.2	0.2
Capital and Financial Account Balance	0.8	-1.7	-3.2	-0.1	3.2	1.1	0.6	0.4	0.0	-0.3	-0.6
Capital account balance	0.7	0.8	0.9	0.9	1.0	1.2	1.1	1.2	1.2	1.3	1.4
Foreign direct investment balance	-0.2	-1.1	-0.6	-1.2	-1.7	-1.1	-1.1	-1.2	-1.1	-1.1	-1.1
Portfolio investment balance	1.7	-2.4	-1.8	1.8	1.9	2.0	2.2	2.4	2.7	2.8	2.9
Financial derivatives	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2
Other investment balance	-1.6	6.0	6.5	0.6	-2.3	-0.7	-0.4	-0.3	-0.1	0.1	0.3
Errors and omissions	0.3	-0.7	-1.0	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	1.2	-0.6	-0.6	0.7	0.1	-0.5	-0.6	-0.6	-0.5	-0.5	0.1
Financing	-1.1	0.6	0.4	-0.6	0.0	0.5	0.6	0.6	0.5	0.5	-0.1
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	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	0.0	0.0
In Percent of GDP (unless indicated)											
Current Account Balance	0.3	3.5	7.3	1.1	-5.1	-2.2	-1.5	-1.1	-0.6	-0.2	0.8
Trade balance of goods and services	1.8	5.3	9.3	4.5	-2.0	0.2	0.8	1.2	1.3	1.4	2.0
Exports	75.2	77.3	73.2	80.5	87.6	74.1	72.7	72.0	72.0	72.6	74.1
Imports	73.4	72.0	63.9	76.0	89.5	73.9	71.9	70.8	70.7	71.3	72.1
Primary income	-3.1	-3.5	-2.9	-3.1	-3.3	-2.6	-2.6	-2.5	-2.1	-1.8	-1.4
Secondary income	1.6	1.7	0.9	0.5	0.2	0.2	0.3	0.2	0.2	0.2	0.2
Capital and Financial Account Balance	1.7	-3.4	-6.4	-0.1	4.8	1.5	0.8	0.4	0.0	-0.4	-0.7
Capital account balance	1.5	1.7	1.9	1.7	1.5	1.6	1.4	1.4	1.4	1.4	1.4
Foreign direct investment balance	-0.5	-2.3	-1.1	-2.2	-2.5	-1.6	-1.4	-1.4	-1.3	-1.2	-1.1
Portfolio investment balance	3.7	-4.9	-3.5	3.3	2.8	2.8	2.8	2.9	3.0	3.1	3.0
Financial derivatives balance	0.0	0.0	0.0	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Other investment balance	-3.4	12.3	13.0	1.0	-3.4	-0.9	-0.5	-0.3	-0.1	0.1	0.4
Overall Balance	2.5	-1.2	-1.1	1.3	0.1	-0.7	-0.7	-0.7	-0.6	-0.5	0.1
Gross External Debt 1/	78.3	66.5	80.5	79.3	68.1	66.5	64.9	63.2	61.6	60.1	58.5
Public	50.1	42.0	46.0	43.8	30.2	26.6	24.8	23.3	22.0	20.9	19.8
Short-term	22.6	11.2	11.0	13.1	8.4	6.8	6.0	5.5	5.1	4.8	4.6
Long-term	27.4	30.8	35.0	30.6	21.8	19.8	18.8	17.8	16.9	16.1	15.3
Private	28.2	24.5	34.5	35.5	37.9	39.9	40.1	39.9	39.6	39.2	38.7
Short-term	17.9	11.9	20.5	21.8	26.9	28.6	29.4	29.5	29.4	29.2	33.7
Long-term	10.3	12.6	14.0	13.7	11.1	11.2	10.7	10.4	10.1	10.0	5.0
Gross external debt (in percent of GS exports)	104.1	86.1	110.1	98.4	77.8	89.7	89.2	87.8	85.6	82.7	79.0
Net external debt	14.4	11.6	0.3	-5.8	-7.3	-6.7	-6.5	-6.8	-7.5	-8.7	-10.6
Net international investment position	-30.2	-23.5	-15.7	-7.4	-6.7	-6.7	-6.3	-5.5	-4.4	-3.0	-0.6
Merchandise export volume (percent change) 2/	6.8	10.1	0.4	17.0	11.9	-1.7	4.6	4.8	5.0	5.1	5.0
Merchandise import volume (percent change) 2/	6.0	6.0	-4.5	19.9	12.3	-1.6	4.7	5.0	5.3	5.3	5.1
Merchandise export prices (percent change) 2/	3.0	0.4	-4.0	6.0	15.6	-7.1	1.4	0.7	0.4	0.6	1.6
Merchandise import prices (percent change) 2/	4.6	-0.5	-5.4	11.8	24.8	-9.5	0.3	0.0	0.0	0.3	0.6
GDP (in billion of Euros)	45.5	48.9	49.8	56.2	66.8	72.1	77.9	83.0	87.6	91.8	96.0

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, 2012–21

(Billions of Euros, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Monetary Authority											
Gross foreign assets	6.4	6.0	7.9	2.9	3.0	4.2	5.7	5.3	4.7	5.9	5.5
Gross foreign liabilities	0.0	0.0	0.1	0.2	0.2	0.2	0.3	0.5	1.2	3.2	1.9
Net foreign assets	6.4	6.0	7.8	2.7	2.8	4.0	5.3	4.7	3.5	2.6	3.6
Net domestic assets	-1.7	-1.0	-1.9	6.5	9.8	11.7	13.4	10.8	17.0	22.1	17.2
Net credit to government	-1.1	-0.5	-1.2	0.0	1.0	-0.1	1.2	0.3	10.1	8.9	10.0
Credit to banks	0.0	0.0	0.0	1.0	0.7	0.6	0.5	0.3	6.3	16.8	7.9
Credit to private sector	0.0	0.0	0.0	1.7	4.8	8.0	8.9	8.2	0.5	0.4	0.2
Other items, net	-0.7	-0.6	-0.7	3.8	3.3	3.3	2.9	1.9	0.2	-3.9	-0.8
Reserve money	4.7	4.9	5.9	9.1	12.6	15.7	18.8	15.5	20.6	24.8	20.9
Currency outside the central bank	3.3	3.4	1.7	6.1	6.2	6.4	6.8	7.1	7.8	8.4	8.3
Currency outside banks	3.0	3.2	1.4	5.7	5.8	6.0	6.3	6.6	7.3	7.8	7.7
Cash in vaults of banks	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.5	0.4	0.5	0.6
Deposit money banks' deposits with BoL	1.4	1.5	4.3	3.1	6.4	9.3	12.0	8.5	12.8	16.4	12.5
Banking Survey											
Net foreign assets	2.8	2.9	4.5	-2.3	-3.5	-2.7	-2.2	-1.8	-3.5	-5.2	-5.8
Monetary authority	6.4	6.0	7.8	2.7	2.8	4.0	5.3	4.7	3.5	2.6	3.6
Banks and other banking institutions	-3.6	-3.1	-3.3	-5.0	-6.2	-6.7	-7.5	-6.5	-7.0	-7.8	-9.5
Net domestic assets	12.9	13.5	12.1	24.3	27.1	27.7	30.0	32.5	44.1	51.3	56.1
Net claims on government 1/	0.3	1.7	0.5	1.7	2.3	0.7	1.9	1.0	10.4	10.0	11.7
Monetary authority	-1.1	-0.5	-1.2	0.0	1.0	-0.1	1.2	0.3	10.1	8.9	10.0
Banks and other banking institutions	1.4	2.1	1.7	1.8	1.3	0.8	0.8	0.6	0.3	1.1	1.7
Credit to private sector	15.3	14.9	14.8	17.1	21.3	25.2	27.2	27.1	19.0	21.4	36.0
Credit to nonbank financial institutions	1.3	0.9	0.9	3.1	6.5	9.9	11.2	10.4	2.3	2.5	10.1
Other items, net	-4.0	-4.0	-4.1	2.5	-3.1	-8.1	-10.3	-5.9	12.3	17.4	-1.7
Broad Money	15.7	16.4	16.6	22.0	23.6	25.0	27.8	30.7	40.6	46.1	50.2
Currency outside banks	3.0	3.2	1.4	5.7	5.8	6.0	6.3	6.6	7.3	7.8	7.7
Deposits	12.7	13.2	15.2	16.3	17.8	19.0	21.5	24.1	33.3	38.2	42.5
In national currency	9.3	9.7	11.3	15.4	16.9	18.1	20.6	23.1	31.7	36.3	39.9
In foreign currency	3.4	3.5	4.0	0.9	0.9	0.9	0.9	1.0	1.6	1.9	2.5
Memorandum Items:											
Reserve money (yearly percent change)	-6.4	4.9	20.9	53.3	38.4	24.9	19.3	-17.4	32.4	20.5	-15.6
Broad money (yearly percent change)	7.2	4.4	1.2	32.9	7.2	5.8	11.4	10.4	32.1	13.5	9.0
Private sector credit (yearly percent change)	-0.8	-2.3	-0.9	4.1	7.1	4.5	6.0	3.3	-1.8	13.4	13.2
Money multiplier	3.3	3.3	2.8	2.4	1.9	1.6	1.5	2.0	2.0	1.9	2.4
Currency outside banks, in percent of deposits	23.6	24.0	8.9	34.9	32.5	31.6	29.3	27.3	22.0	20.5	18.2
Foreign-currency deposits (percent of total deposits)	26.4	26.5	26.0	5.5	5.1	4.8	4.1	4.1	4.7	5.0	6.0
Foreign-currency loans (percent of total loans) 2/	72.7	72.1	72.7	0.9	0.6	0.5	0.4	0.3	0.2	0.2	0.1
Velocity of broad money	2.1	2.1	2.2	1.7	1.6	1.7	1.6	1.6	1.2	1.2	1.3
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	4.9	6.1	0.0
Gross official reserves (billions of euros) 3/	6.4	6.0	7.9	2.9	3.0	4.2	5.7	5.3	4.7	5.9	5.5
GDP	33.4	35.0	36.6	37.3	38.9	42.3	45.5	48.9	49.8	56.2	66.8

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 Systems Data, 2013–22

(In percent unless otherwise indicated)

	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18	Dec-19	Dec-20	Dec-21	Dec-22
Capital adequacy										
Regulatory capital to risk-weighted assets 1/ 2/	17.6	21.3	24.9	19.4	19.1	18.6	23.7	24.0	23.5	20.4
Regulatory Tier 1 capital to risk-weighted assets 1/ 2/	17.1	20.9	24.3	19.1	18.8	18.5	23.3	23.6	23.2	20.2
Capital to assets 1/	12.6	12.9	11.1	10.4	9.4	8.6	9.1	8.1	7.1	6.0
Asset quality										
Nonperforming loans to capital 1/ 3/	42.6	46.9	38.3	35.5	28.6	26.9	15.2	15.0	8.6	7.2
Nonperforming loans net of provisions to capital 1/ 3/	19.7	29.8	25.0	23.2	18.8	20.0	10.5	10.4	6.0	4.6
Nonperforming loans to total (non-interbank) loans 1/ 3/	11.6	7.0	5.7	4.1	3.1	2.5	1.5	1.4	0.7	0.6
Nonperforming loans to capital 1/ 3/ 4/	42.6	46.9	38.3	35.5	28.6	26.9	15.2	15.0	8.6	7.2
o/w impaired loans to capital 1/ 3/ 4/	27.4	29.1	23.4	23.1	18.4	26.0	14.3	14.2	7.7	6.9
o/w non-impaired loans overdue more than 60 days to capital 1/ 3/ 4/ 14/	15.2	8.0	6.4	7.9	5.8	..	..	..	..	..
Nonperforming loans net of provisions to capital 1/ 3/ 4/ 5/	19.7	29.8	25.0	23.2	22.9	20.0	10.5	10.4	6.0	4.6
Nonperforming loans to total (non-interbank) loans 3/ 4/	11.0	7.0	5.7	4.1	4.1	2.5	1.5	1.4	0.7	0.6
o/w impaired loans to total (non-interbank) loans 4/	8.5	4.7	3.8	3.1	2.2	2.4	1.4	1.3	0.6	0.5
o/w non-impaired loans overdue more than 60 days to total (non-interbank) loans 4/ 14	2.5	1.2	1.0	0.9	0.6	..	..	..	..	..
Impairment losses to total (non-interbank) loans 6/ 7/	4.2	2.5	2.0	1.4	1.1	0.8	0.6	0.6	0.4	0.4
Impairment losses to nonperforming loans 3/ 4/ 6/ 7/	53.7	36.5	34.7	34.7	30.8	33.4	39.4	43.8	56.8	77.7
Sectoral distribution of corporate loans 8/										
Agriculture, forestry and fishing	2.8	2.9	3.6	3.7	3.6	3.6	3.2	3.5	3.0	2.8
Mining and quarrying	0.5	0.5	0.5	0.5	0.5	0.4	0.3	0.3	0.2	0.2
Manufacturing	17.9	15.7	14.7	14.2	14.3	14.0	14.9	14.7	14.6	14.3
Electricity, gas, steam and air conditioning supply	7.6	9.5	11.0	8.7	4.7	5.3	7.4	5.7	5.3	7.2
Water supply; sewerage, waste management and remediation activities	0.8	1.0	1.0	0.9	0.8	0.6	0.6	0.7	1.0	1.0
Construction	8.6	7.3	6.1	5.4	5.2	3.7	3.1	2.9	3.1	4.0
Wholesale and retail trade; repair of motor vehicles and motorcycles	19.3	20.3	21.9	21.3	22.7	25.4	23.0	19.4	21.3	20.3
Transportation and storage	5.7	5.0	5.8	5.8	6.1	8.7	9.3	9.0	8.1	5.4
Accommodation and food service activities	2.7	2.6	2.4	2.4	2.4	3.0	2.6	3.1	2.3	1.9
Information and communication	0.8	0.9	0.8	2.4	2.4	2.0	1.8	1.1	0.8	1.0
Real estate activities	28.3	27.8	26.3	26.6	25.8	25.0	27.0	31.9	32.5	32.2
Professional, scientific and technical activities	2.6	3.7	2.6	3.2	5.0	2.6	1.8	2.2	3.0	3.3
Administrative and support service activities	1.0	1.8	2.0	3.0	4.4	2.6	2.4	2.9	2.6	3.6
Remaining activities	1.2	1.1	1.3	1.8	2.2	3.0	2.6	2.5	2.2	2.8
Residential real estate loans to total (non-interbank) loans	38.0	28.7	29.8	31.3	31.3	31.1	30.1	27.8	24.5	22.4
Large exposures to regulatory capital 1/ 5/	..	..	..	..	..	..	..	..	..	..
Earnings and profitability										
RoE 1/ 9/	8.9	8.1	9.0	14.0	12.5	12.7	12.3	10.7	10.3	10.6
RoA 9/	1.2	1.3	0.9	1.0	1.1	1.3	1.1	0.8	0.8	0.9
Interest margin to gross income	24.3	49.9	49.7	50.3	53.3	53.7	52.2	53.9	51.2	46.1
Noninterest expenses to gross income	60.5	56.6	55.3	50.9	53.2	50.5	47.5	52.7	55.7	60.8
Trading and foreign exchange gains (losses) to gross income	9.9	8.2	6.2	4.3	7.2	6.2	6.2	6.3	7.4	10.5
Personnel expenses to noninterest expenses	38.3	38.7	42.7	43.6	41.7	42.2	43.2	43.5	41.3	23.3
Liquidity										
Liquidity coverage ratio	..	..	..	266.3	281.9	254.2	272.4	743.3	392.3	389.6
Liquidity ratio (liquid assets to current liabilities) 10/	41.2	43.6	..	..	..	..	..	..	..	..
Liquid assets to total assets 10/	24.0	29.3	..	15.3	23.6	25.6	28.9	37.0	43.7	40.5
Current liabilities to total liabilities 10/	73.1	81.6	..	..	..	..	..	..	..	..
3-month VILIBOR-EURIBOR spread, b.p. 8/	12.0	10.0	..	..	..	..	..	..	..	..
Spread between highest and lowest interbank rate, b.p. 10/	39.0	25.0	..	..	..	..	..	..	..	..
Loan to deposit ratio in the banking sector 11/	121.5	101.6	98.6	99.0	94.6	89.3	81.9	61.4	64.0	55.9
Foreign exchange risk										
Foreign-currency-denominated loans to total (non-interbank) loans 12/	68.7	..	..	..	..	..	..	..	..	..
Foreign-currency-denominated liabilities to total liabilities 12/	48.2	..	..	..	..	..	..	..	..	..
Net open position in foreign exchange to regulatory capital 1/ 13/	0.4	0.4	0.1	0.0	0.0	0.0	0.0	..	..	..
Memo item										
Provisioning (in percent of NPLs)	16.5	..	..	..	..	..	..	..	..	..

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

General notes:

A. Banking system data was compiled by aggregating banks solo (i.e. no cross-border cross-sector consolidation) data.

B. No intra-sector adjustments were made.

C. FSIs were mostly derived from supervisory data and comprise all banks and foreign bank branches incorporated in Lithuania, except if stated otherwise.

D. 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 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Re
No 648/2012.

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 the Board of the Bank of Lithuania of 29 January 2004.

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 were in euros, to which the national currency 'litas' was pegged via a currency board arrangement until 2015 when the euro was introduced as a national currency.

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

14/ As of 2018, breakdown for loans that are overdue more than 60 days is no longer available in FINREP.

Annex I. Risk Assessment Matrix[1]

Source of Risks, Likelihood, and Time Horizon	Impact on Lithuania	Recommended Policy Response
External Risks		
High (Short-term) **Intensification of regional conflict(s).** Escalation of Russia's war in Ukraine or other regional conflicts and resulting economic sanctions disrupt trade (e.g., energy, food, tourism, and/or critical supply chain components), remittances, refugee flows, FDI and financial flows, and payment systems	**High** The direct trade impact with Russia, Ukraine and Belarus will be small. The main impact will come through rising commodity prices and from a weaker global outlook and confidence effects.	Use fiscal space to provide targeted relief to firms and households and let automatic stabilizers work fully provided that both inflation and growth are negatively affected.
High (Short-term) **Social discontent.** Supply shocks, high inflation, real wage drops, and spillovers from crises in other countries worsen inequality, trigger social unrest, and give rise to financing pressures and damaging populist policies with possible spillovers to other EMDEs. This exacerbates imbalances, slows growth, and triggers market repricing.	**Low** The economy has shown resilience to pandemic related shocks, while price increases and shortages link to the War in Ukraine are unlikely to result in social discontent given broad consensus on support for Ukraine.	Provide targeted support to ameliorate the impact of higher food/energy prices on vulnerable households.
Medium (Short-term) **Commodity price volatility.** A succession of supply disruptions (e.g., due to conflicts and export restrictions) and demand fluctuations (e.g., reflecting China reopening) causes recurrent commodity price volatility, external and fiscal pressures, and social and economic instability.	**High/Medium** Further increases in energy and food prices will put additional pressure on consumers and firms. However, their balance sheets are strong, and the government has fiscal space to provide support.	Allow price signals to work and provided targeted support to vulnerable groups and those most affected.
High (Short-term) **Abrupt global slowdown or recession.** Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and markets fragmentation.	**High** A marked slowdown in the global economy will impact Lithuania through its impact on the global economy, and to key EU trading partners.	Allow automatic stabilizers to work and depending on the magnitude of the slowdown and given weak social safety net, provide targeted support to the most vulnerable.
Medium (Short-term) **Monetary policy miscalibration.** Amid high economic uncertainty and volatility, major central banks slow monetary policy tightening or pivot to loosen monetary policy stance prematurely, de-anchoring inflation expectations and triggering a wage-price spiral in tight labor markets.	**Medium** A premature loosening of the monetary stance will not help reduce high inflation and would increase the risk of persistently high inflation with a negative impact on competitiveness.	Fiscal policy will have to more proactively reduce inflationary pressures by adopting a tighter stance.

[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). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. The conjunctural shocks and scenarios highlight risks that may materialize over a shorter horizon (between 12 to 18 months) given the current baseline. Structural risks are those that are likely to remain salient over a longer horizon.

Source of Risks, Likelihood, and Time Horizon	Impact on Lithuania	Recommended Policy Response
Medium (Short-term) **Systemic financial instability.** Sharp swings in real interest rates, risk premia, and assets repricing amid economic slowdowns and policy shifts trigger insolvencies in countries with weak banks or non-bank financial institutions, causing markets dislocations and adverse cross-border spillovers.	**Medium** Banks have enough capital and liquidity buffers to absorb shocks, but there are potential pockets of vulnerability and the risk of a disorderly correction of the real estate market	Risks and potential vulnerabilities require close monitoring. If there are credit supply disruptions or a disorderly correction of the real estate market, macroprudential policies will have to be relaxed.
High (Long-term) **Deepening geo-economic fragmentation.** Broader and deeper conflict(s) and weakened international cooperation leads to a more rapid reconfiguration of trade and FDI, supply disruptions, technological and payments systems fragmentation, rising input costs, financial instability, fracturing of international monetary and financial systems, and lower potential growth.	**Medium** The slowdown in global growth and trade will affect Lithuania's overall trade prospects weakening the labor market.	Continue EU trade integration to secure access to a large market. Pursue education and healthcare reform to shift the labor force to higher value-added sectors with fast growing labor demand.
Medium (Short-term) **Cyberthreats.** Cyberattacks on critical domestic and/or international physical or digital infrastructure (including digital currency and crypto ecosystems) trigger financial and economic 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.
Medium (Long-term) **Extreme climate events.** Extreme climate events cause more severe than expected damage to infrastructure (especially in smaller vulnerable economies) and loss of human lives and livelihoods, amplifying supply chain disruptions and inflationary pressures, causing water and food shortages, and reducing growth.	**Medium** While Lithuania could benefit from higher temperatures, associated increased volatility entails risks to biodiversity, food production, infrastructure, and weather sensitive activities.	Continue to strengthen climate-related policies along with energy security, including increasing the share of renewables.
Domestic Risks		
Low/Medium (Long-term) **Risks to competitiveness.** Wage growth exceeds productivity growth in tradeable sectors for an extended period.	**Medium** Competitiveness and growth potential would suffer. However, real wages and productivity have traditionally been closely linked and temporary deviations have been self-correcting.	Proactively use fiscal policy to reduce inflationary pressures. Redouble efforts to implement structural reform programs. Avoid large minimum wage increases.
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.	Accelerate the implementation of elusive structural reforms and elaborate a medium- term fiscal plan that raises potential and meets social needs.

Annex II. Implementation of Past IMF Recommendations

	Education
Issue	Oversized system does not reflect demographics resulting in high spending and poor outcomes. System leads to mismatch of education and occupational choices.
Recommendations	Address overcapacities (reduce number of teachers and consolidate school and university infrastructure). Review nexus between universities, financial incentives, and quality standards.
Authorities' actions	Parliament approved a decision on the amendments to the rules in 2021 that is broadly in line with recommendations and the new requirements entered into force in 2022 for general education schools and higher education. But implementation was largely decentralized, especially for the reforms in higher education. The pandemic and war have further delayed reform efforts.
	Healthcare
Issue	The system remains hospital-care centered while out-patient and long-term care for elderly lag.
Recommendations	Continue reorganizing and rationalizing the 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.
Authorities' actions	The authorities diverted more financial resources to the health sector during covid and renewed implementation efforts, including introduction of legal changes to allow for joint ownership of hospitals with municipalities. The government approved two programs for 2022-2030 to improve the quality and efficiency of the health care system in the country.
	Tax Policy
Issue	Low overall tax collection with high labor tax wedge and low wealth and environmental-related taxes. Tax system has limited redistributive impact.
Recommendations	Reduce social security contributions for low wage earners. Rebalance tax system from indirect and labor taxes towards wealth, capital and environmental taxes. Reduce tax exemptions and privileged regimes.
Authorities' actions	The authorities recently proposed tax reform is in the right direction, but the revenue gains would be low and not strong enough to achieve climate goals.
	Labor Market
Issue	Flexible labor market with high skill-mismatches and labor shortages mostly in high-skill industries. High minimum wage introduces distortions in regional areas with low wages.
Recommendations	Reduce the tax wedge. Strengthen ALMPs, including life-long learning and apprenticeships, and increase its funding. Reduce barriers to non-EU migration and increase retirement age. Pause minimum wage increase and consider having differentiated minimum wage across regions.
Authorities' actions	Enhanced ALMPs (introduced internships, mobility support, recognition of self-education). Increased minimum wage by 15 percent in 2022 to 50 percent of average wage. Restrictions on immigration were eased and migration from Ukraine has been facilitated.
	Pensions
Issue	Low and falling replacement ratios for a rapidly aging population. Highly redistributive—currently the most effective redistributive policy tool—but not targeted at the poor.

Recommendations	Link retirement age to life expectancy and tighten early retirement. Raise gross pensions (to at least preserve replacement ratios) and subject them to progressive PIT. Strengthen multi-pillar system by funding non-contributory basic pensions through general revenues and by making payments to second pillar compulsory. Scale back incidence of disability pensions.
Authorities' actions	Multi-pillar system was strengthened as basic pension and commensurate social contributions were transferred to the state budget. Participation in Pillar II became mandatory with limited opting-out. A ceiling on social contributions was established and a new PIT bracket was introduced. A ceiling on private pension fund fees was introduced and the minimum amount to purchase an annuity reduced. The retirement age has not been increased. One-off increases in pension benefits outside of the indexation formula are commonly introduced with possibility to undermine the system's financial sustainability. In 2021, two third pillar pension funds were established with environmental sustainability goals.
	Green Transformation
Issue	Lithuania is increasingly vulnerable to climate change, while geopolitical tensions have brought energy security to the fore.
Recommendations	A comprehensive carbon tax is necessary to achieve the authorities' emission Reduction objectives for 2030 and reduce energy imports by (i) reducing fossil fuels, (ii) investing in low-emission transportation, and (iii) raising energy efficiency. The introduction of an economy-wide carbon tax—set to gradually increase to EUR50 per metric ton of CO_2 emissions by 2030—would help achieve these goals.
Authorities' actions	The authorities have proposed new environmental taxes, but these are not ambitious enough to deliver the climate objectives and still being discussed in parliament.

Annex III. External Sector Assessment

Overall Assessment: *The external position of Lithuania in 2022 was substantially weaker than the level implied by fundamentals and desirable policies. This was driven by the large energy price hike which has already subsided. Over the medium-term and under the policies expected under the baseline scenario and as energy prices decline, Lithuania's current account balance is expected to remain in the vicinity of the norm. Therefore, there is no concern about long-term misalignments.*

Potential Policy Responses: *Given that most of the deterioration in the current account in 2022 is temporary, the current account is expected to converge over time to its norm under the current baseline. The energy transition strategy by the government is essential to reduce fuel energy imports which could remain permanently elevated should fuel prices not return to pre-crisis levels.*

Foreign Assets and Liabilities: Position and Trajectory

Background. Between 2009 and 2021, the NIIP has strengthened almost every year by a total of more than 50 percentage points of GDP, reaching a low of -7.2 percent of GDP in 2021. In 2022, the NIIP deteriorated slightly in absolute terms, driven by the current account deficit. However, strong nominal GDP growth resulted in a further improvement of the NIIP relative to GDP. Gross assets declined to 101.9 percent of GDP, while liabilities fell to 108.6 percent. The trend improvement over the past 14 years reflects the improvement in international competitiveness that dwarfs the small deterioration in 2022 that is largely driven by the likely temporary energy price hike.

Assessment. The current NIIP and its projected path do not imply risks to external sustainability.

2022 (% GDP)	NIIP: -6.7	Gross Assets: 101.9	Debt Assets: 15.9	Gross Liab.: 108.6	Debt Liab.: 25.7

Current Account

Background. The 2022 current account turned into a deficit of 5.1 percent of GDP, much smaller than the surplus of 1.4 percent in 2021 and of 7.3 percent in 2020. Most of the deterioration is explained by the energy trade balance, which declined by 7 percent of GDP in 2022 with net non-oil goods and services exports providing a partial offset.

Assessment. The EBA-lite CA model estimates that the current account gap is -4.5 percent of GDP in 2022 and a cyclically adjusted CA of -3.9 percent while the norm envisages a surplus of 0.7 percent of GDP. The gap is largely driven by the energy price hike with policies providing a sizable offset of +3.3 percent of GDP, with public health expenditures and the cyclically adjusted fiscal balance being the main contributors.

Table 1: Lithuania: Model Estimates for 2022 (in percent of GDP)

	CA model 1/	REER model
CA-Actual	**-5.1**	
Cyclical contributions (from model) (-)	-0.7	
COVID-19 adjustor (-)	0.0	
Additional temporary/statistical factors (-)	0.0	
Natural disasters and conflicts (-)	-0.5	
Adjusted CA	**-3.9**	
CA Norm (from model) 2/	**0.7**	
Adjustments to the norm (+)	0.0	
Adjusted CA Norm	**0.7**	
CA Gap	**-4.5**	**0.7**
o/w Relative policy gap	3.3	
Elasticity	-0.5	
REER Gap (in percent)	**8.4**	**-1.3**

1/ Based on the EBA-lite 3.0 methodology

2/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate

Background. The real effective exchange rate appreciated almost 6 percent in 2022, and about 12 percent during the last three years. As of March, it has appreciated by 5.6 percent relative to the 2022 average level.

Assessment. While the current account model suggests an REER gap of 8.4 percent, the expectedly temporary nature of the current account suggests that a potentially large part of this overvaluation may be temporary as well. The REER model, in contrast and less plausibly, estimates an REER gap of -1.3 percent, consistent with a CA gap of 0.7 percent. The real appreciation during 2022 reflects higher inflation than in trading partners related to a stronger impact of increased energy prices.

Capital and Financial Accounts: Flows and Policy Measures

Background. Lithuania experienced strong capital inflows during 2022 reflecting financing needs related to elevated energy prices. The inflows largely occurred through accelerated FDI and portfolio investments, reversing the outflows in 2021.

Assessment. Gross debt has declined by 10 percentage points of GDP, a large part of it held by the public sector. Risks are further ameliorated by the holding of significant assets including sizable reserve holdings by the central bank.

FX Intervention and Reserves Level

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

Assessment. Reserves in the euro area tend to be low relative to standard metrics, but the currency is free floating.

Annex IV. Debt Sustainability Analysis

Figure 1: Lithuania: Risk of Sovereign Stress

Horizon	Mechanical Signal	Final Assessment	Comments
Overall	...	Low	The overall risk of sovereign stress is low, with low levels of vulnerability in the near- and medium-term and moderate in the long-term.
Near-term 1/			
Medium-term	Low	Low	Medium-term risks are assessed as low in line with a mechanical low signal on the basis of the strength of institutions and prudent policies, the low level of public debt as a share of GDP, the access to wider pool of investors in Europe, and the ECB's stabilizing role.
Fan chart	Moderate	...	
GFN	Low	...	
Stress test	...	...	
Long-term	...	Moderate	Long-term risks are moderate as aging-related expenditures on health and social security will eventually feed into debt dynamics.
Sustainability Assessment 2/	Not required for surveillance countries	Sustainable	The projected debt path is expected to stabilize and GFNs will remain at manageable levels, with the reinstatement of the domestic fiscal rule in 2024 and beyond. Therefore debt is assessed as sustainable.
Debt stabilization in the baseline			Yes

DSA Summary Assessment

Commentary: Lithuania is at a low overall risk of sovereign stress and debt is sustainable. Most indicators have started to normalize as the recovery from the COVID-19 pandemic has proceeded and the economy has suffered a transitory contraction in activity due to the terms-of-trade shock caused by Russia's invasion of Ukraine. Accordingly, public debt is expected to remain firmly on a downward path over the medium term, with no difficulty in financing. Over the longer run, Lithuania should continue with structural reforms to tackle risks arising from population aging. However, even in that case, the debt-to-GDP ratio is comfortably below the EU debt threshold of 60 percent.

Source: Fund staff.

Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.

1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.

2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.

Figure 2: Lithuania: Debt Coverage and Disclosures

						Comments
1. Debt coverage in the DSA: 1/	CG	GG	NFPS	CPS	Other	
1a. If central government, are non-central government entities insignificant?					n.a.	
2. Subsectors included in the chosen coverage in (1) above:						
	Subsectors captured in the baseline				Inclusion	
CPS / NFPS / GG: expected / CG	1 Budgetary central government				Yes	
	2 Extra budgetary funds (EBFs)				No	Not applicable
	3 Social security funds (SSFs)				Yes	
	4 State governments				No	Not applicable
	5 Local governments				Yes	
	6 Public nonfinancial corporations				Yes	
	7 Central bank				Yes	
	8 Other public financial corporations				Yes	
3. Instrument coverage:	Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/	
4. Accounting principles:	Basis of recording		Valuation of debt stock			
	Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/	
5. Debt consolidation across sectors:		Consolidated		Non-consolidated		

Color code: chosen coverage; Missing from recommended coverage; Not applicable

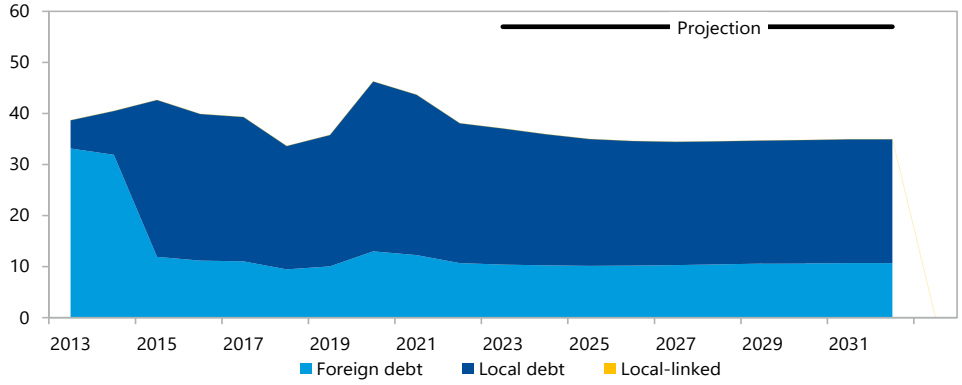
Reporting on Intra-Government Debt Holdings

Issuer \ Holder				Budget. central govt	Extra-budget. funds (EBFs)	Social security funds (SSFs)	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
CPS / NFPS / GG: expected / CG	1	Budget. central govt										0
	2	Extra-budget. funds										0
	3	Social security funds										0
	4	State govt.										0
	5	Local govt.										0
	6	Nonfin pub. corp.										0
	7	Central bank										0
	8	Oth. pub. fin. corp										0
		Total		0	0	0	0	0	0	0	0	0

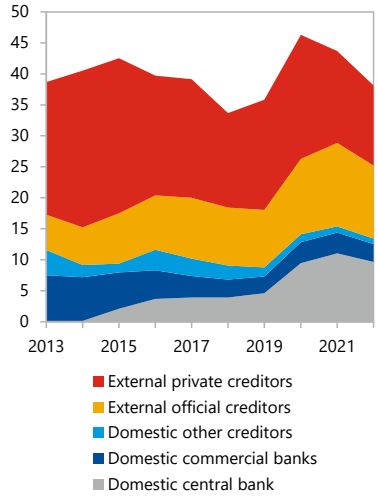
1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.
4/ Includes accrual recording, commitment basis, due for payment, etc.
5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.
7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

Figure 3: Lithuania: Public Debt Structure Indicators

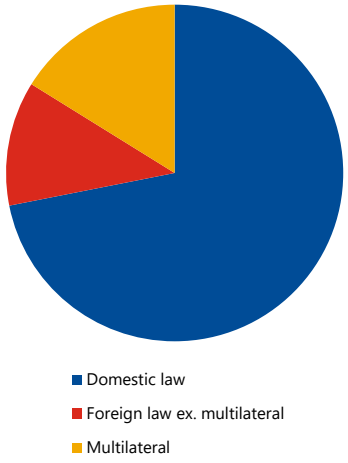
Debt Type (percent of GDP)



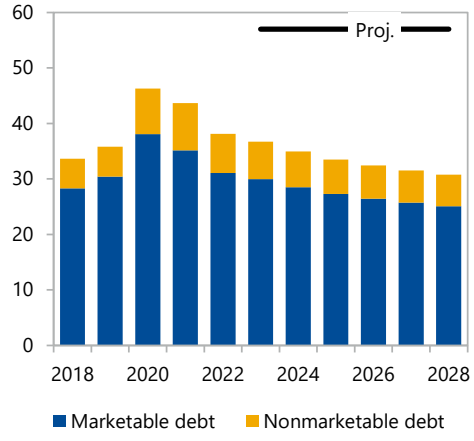
Public Debt by Holder (percent of GDP)



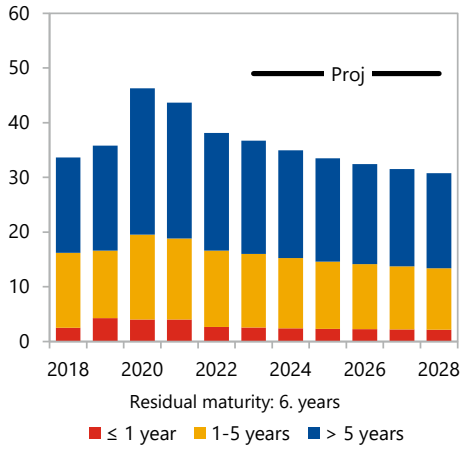
Public Debt by Governing Law, 2022 (percent)



Debt by Instruments (percent of GDP)



Public Debt by Maturity (percent of GDP)



Note: The perimeter shown is general government.

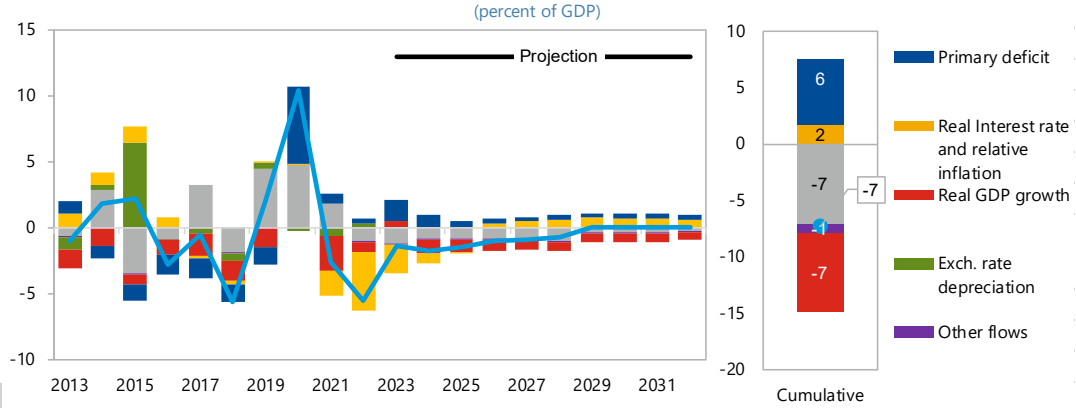
Figure 4: Lithuania: Baseline Scenario

(Percent of GDP unless indicated otherwise)

	Actual	Medium-term projection						Extended projection			
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Public debt	38.1	36.7	35.0	33.5	32.4	31.5	30.8	30.8	30.8	30.8	30.8
Change in public debt	-5.6	-1.4	-1.8	-1.5	-1.1	-0.9	-0.8	0.0	0.0	0.0	0.0
Contribution of identified flows	-4.6	-0.1	-0.9	-0.7	-0.2	0.0	0.2	0.4	0.4	0.3	0.2
Primary deficit	0.4	1.6	1.0	0.5	0.4	0.3	0.4	0.3	0.3	0.3	0.3
Noninterest revenues	35.8	38.1	36.6	36.1	35.5	35.5	35.4	35.4	35.4	35.4	35.4
Noninterest expenditures	36.1	39.6	37.6	36.5	35.9	35.8	35.7	35.7	35.7	35.7	35.7
Automatic debt dynamics	-4.8	-1.6	-1.8	-1.1	-0.6	-0.2	0.0	0.1	0.1	0.1	0.0
Real interest rate and relative inflation	-4.4	-2.2	-0.8	-0.1	0.3	0.5	0.6	0.7	0.7	0.7	0.6
Real interest rate	-5.8	-2.9	-1.0	-0.3	0.2	0.4	0.6	0.7	0.7	0.7	0.6
Relative inflation	1.4	0.7	0.3	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Real growth rate	-0.8	0.5	-1.0	-0.9	-0.8	-0.7	-0.7	-0.6	-0.6	-0.6	-0.6
Real exchange rate	0.4	...	...	...	...	...	...	...	...	...	...
Other identified flows	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other transactions	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Contribution of residual	-1.0	-1.2	-0.8	-0.8	-0.8	-0.9	-1.0	-0.4	-0.4	-0.3	-0.2
Gross financing needs	4.6	5.5	6.6	8.2	10.6	12.2	13.9	13.0	13.6	14.0	13.9
of which: debt service	4.3	4.0	5.8	7.8	10.3	11.9	13.6	12.7	13.3	13.7	13.6
Local currency	3.1	2.7	3.9	5.4	7.1	8.2	9.4	8.7	9.1	9.3	9.2
Foreign currency	1.2	1.3	1.8	2.5	3.2	3.7	4.2	4.0	4.3	4.4	4.4
Memo:											
Real GDP growth (percent)	1.9	-1.4	2.9	2.7	2.5	2.2	2.1	2.1	2.1	2.1	2.1
Inflation (GDP deflator; percent)	16.7	9.4	5.0	3.8	2.9	2.5	2.4	2.4	2.4	2.4	2.4
Nominal GDP growth (percent)	18.9	7.9	8.0	6.6	5.5	4.8	4.6	4.6	4.6	4.6	4.6
Effective interest rate (percent)	1.0	1.4	2.0	2.9	3.5	3.9	4.3	4.7	4.7	4.7	4.3

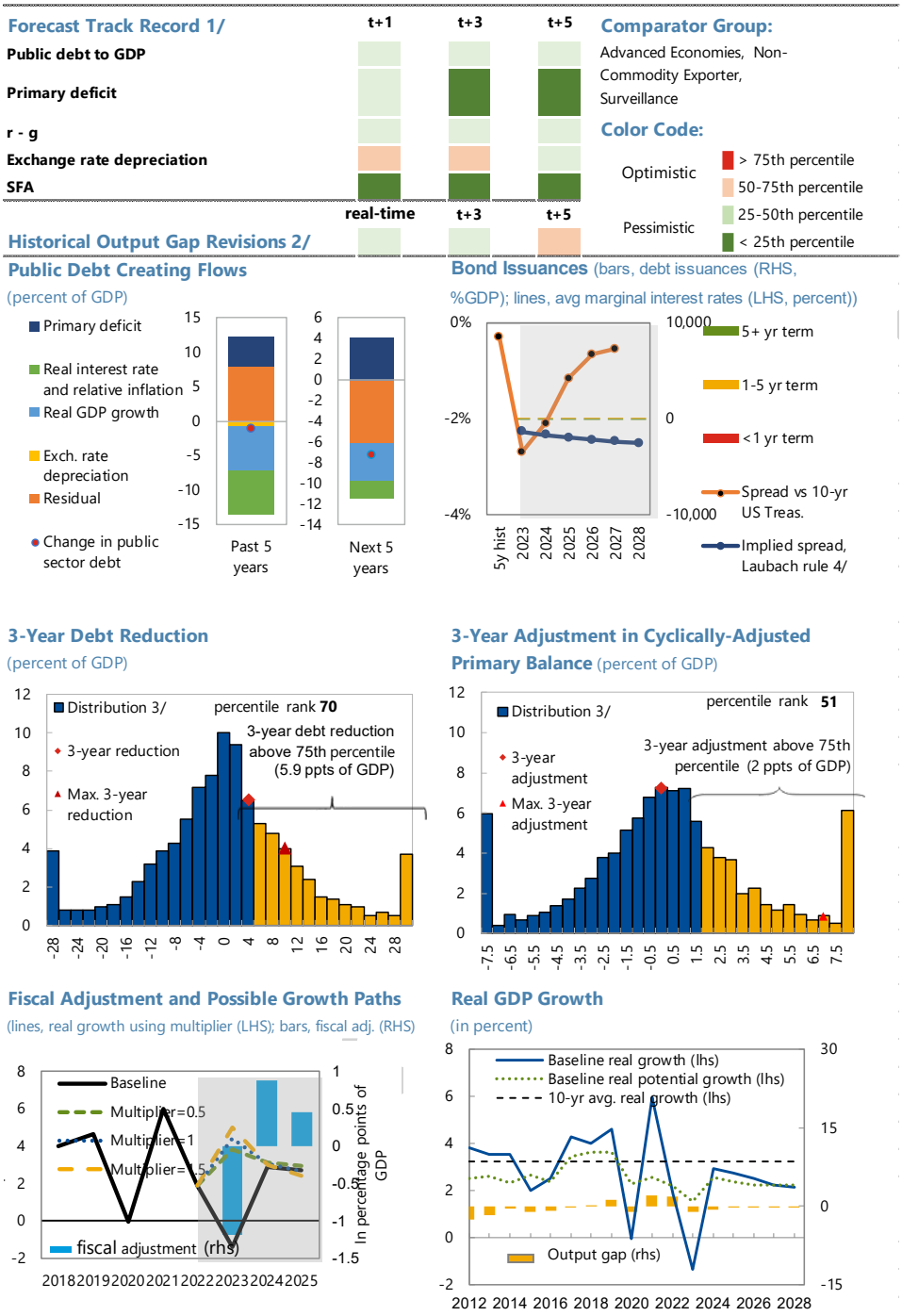
Contribution to Change in Public Debt

(percent of GDP)



Staff commentary: Public debt is projected to decline over the medium term as well as during the extended projection period, reflecting expectations of a narrowing of primary deficits and stable economic conditions.

Figure 5: Lithuania: Realism of Baseline Assumptions



Commentary: Realism analysis does not point to major concerns.

Source : IMF Staff.

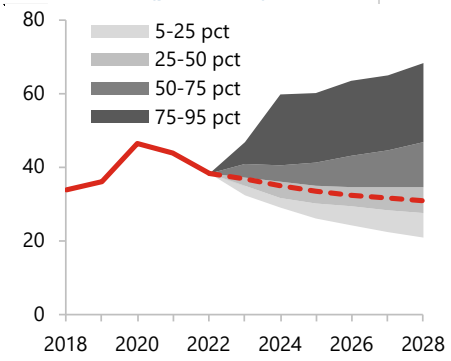
1/ Projections made in the October and April WEO vintage. Program status not used in creating comparator group due to lack of data.)

2/ Calculated as the percentile rank of the country's output gap revisions (defined as the difference between real time/period ahead estimates and final estimates in the latest October WEO) in the total distribution of revisions across the data sample.

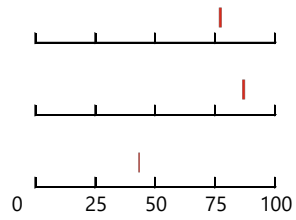
3/ Data cover annual observations from 1990 to 2019 for MAC advanced and emerging economies. Percent of sample on vertical axis.

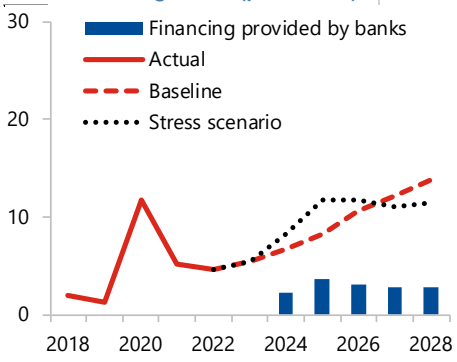
4/ The Laubach (2009) rule is a linear rule assuming bond spreads increase by about 4 bps in response to a 1 ppt increase in the projected debt-to-GDP ratio.

Figure 6: Lithuania: Medium-Term Risk Assessment

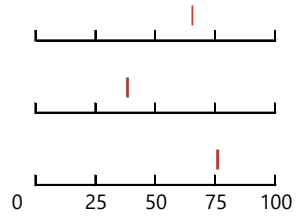


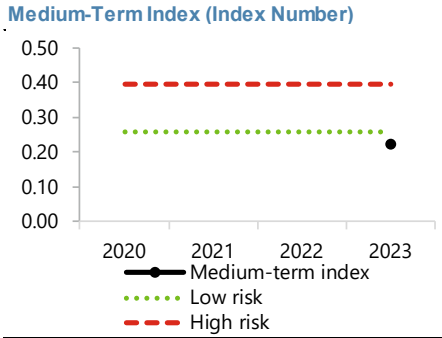
Debt Fanchart Module	Value	Contrib [1/]	Percentile in peer group [2/]
Fanchart width *(percent of GDP)*	47.3	0.7	
Probability of debt non-stabilization *(percent)*	55.3	0.5	
Terminal debt-to-GDP x institutions index	9.9	0.2	
Debt fanchart index (DFI)		1.4	
Risk signal: [3/]		Moderate	





Gross Financing Needs (GFN) Module	Value	Contrib
Average baseline GFN *(percent of GDP)*	9.5	3.2
Banks' claims on the gen govt *(pct bank assets)*	3.7	1.2
Chg. In banks' claims in stress *(pct banks' assets)*	8.6	2.9
GFN financeability index (GFI)		7.3
Risk signal: [4/]		Low





Medium-Term Risk Analysis

	Value	Norm. Value	Weight	Contribution
Debt fanchart index (normalized)	1.37	0.30	0.50	0.15
GFN finaceability index (normalized)	7.32	0.14	0.50	0.07
Medium-term index		0.2		
Risk signal: 5/		Low		
Final assessment:		Low		

Prob. of missed crisis, 2023-2028, if stress not predicted: 9.1 pct.
Prob. of false alarms, 2023-2028, if stress predicted: 48.9 pct.

Source: IMF staff estimates and projections.

1/ See Annex IV of IMF, 2022, Staff Guidance Note on the Sovereign Risk and Debt Sustainability Framework for details on index calculation.
2/ The comparison group is advanced economies, non-commodity exporter, surveillance.
3/ The signal is low risk if the DFI is below 1.13; high risk if the DFI is above 2.08; and otherwise, it is moderate risk.
4/ The signal is low risk if the GFI is below 7.6; high risk if the DFI is above 17.9; and otherwise, it is moderate risk.
5/ The signal is low risk if the GFI is below 0.26; high risk if the DFI is above 0.40; and otherwise, it is moderate risk.

Table 1: Lithuania: External Debt Sustainability Framework, 2018–2028

(in percent of GDP, unless otherwise specified)

	Actual							Projections						
	2018	2019	2020	2021	2022			2023	2024	2025	2026	2027	2028	Debt-stabilizing non-interest current account 6/
Baseline: External debt	75.4	66.1	81.2	75.6	68.5			**66.3**	**64.9**	**63.2**	**61.6**	**60.1**	**58.5**	**-3.5**
Change in external debt	-12.6	-9.4	15.1	-5.6	-7.1			-2.1	-1.5	-1.6	-1.6	-1.5	-1.6	
Identified external debt-creating flows (4+8+9)	-12.4	-7.0	-12.3	-14.5	-0.9			1.0	-2.3	-2.5	-2.9	-3.1	-4.0	
Current account deficit, excluding interest payments	-1.4	-4.8	-8.3	-1.8	4.5			1.5	0.3	-0.1	-0.7	-1.0	-1.9	
Deficit in balance of goods and services	-1.8	-5.3	-9.3	-4.5	2.0			-0.2	-0.8	-1.2	-1.3	-1.4	-2.0	
Exports	75.2	77.3	73.2	80.5	87.6			74.1	72.7	72.0	72.0	72.6	74.1	
Imports	73.4	72.0	63.9	76.0	89.5			73.9	71.9	70.8	70.7	71.3	72.1	
Net non-debt creating capital inflows (negative)	-2.2	-2.1	-2.5	-1.7	-1.8			-2.0	-2.0	-2.0	-2.0	-2.0	-2.1	
Automatic debt dynamics 1/	-8.7	-0.2	-1.4	-11.1	-3.6			1.6	-0.6	-0.4	-0.3	-0.1	0.0	
Contribution from nominal interest rate	1.1	1.2	1.0	0.6	0.6			0.7	1.2	1.2	1.2	1.2	1.2	
Contribution from real GDP growth	-3.1	-3.4	0.0	-4.2	-1.3			0.8	-1.8	-1.7	-1.5	-1.3	-1.2	
Contribution from price and exchange rate changes 2/	-6.8	2.1	-2.5	-7.6	-2.9			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-0.2	-2.4	27.4	8.9	-6.2			-3.1	0.8	0.9	1.3	1.6	2.5	
External debt-to-exports ratio (in percent)	100.3	85.4	110.9	93.9	78.2			89.6	89.2	87.8	85.6	82.7	79.0	
Gross external financing need (in billions of US dollars) 4/	24.5	21.9	12.8	21.0	28.7			29.9	32.3	34.2	35.2	36.4	36.3	
in percent of GDP	45.5	40.0	22.5	31.6	40.7	10-Year	10-Year	38.3	38.5	38.2	37.3	36.7	35.0	
Scenario with key variables at their historical averages 5/								**66.3**	**63.4**	**60.1**	**56.9**	**53.8**	**51.5**	**-3.9**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation						For debt stabilization	
Real GDP growth (in percent)	4.0	4.6	0.0	6.0	1.9	3.2	1.7	-1.4	2.9	2.7	2.5	2.2	2.1	
GDP deflator in US dollars (change in percent)	8.3	-2.7	3.9	10.3	4.0	2.0	7.5	12.4	4.4	3.8	3.0	2.6	2.4	
Nominal external interest rate (in percent)	1.5	1.6	1.6	0.9	0.8	1.9	0.7	1.2	1.9	2.0	2.1	2.1	2.1	
Growth of exports (US dollar terms, in percent)	15.1	4.7	-1.7	28.6	15.2	7.1	13.7	-6.2	5.5	5.5	5.6	5.9	6.7	
Growth of imports (US dollar terms, in percent)	16.0	-0.1	-7.9	39.1	24.8	7.7	16.7	-8.5	4.6	5.1	5.4	5.8	5.9	
Current account balance, excluding interest payments	1.4	4.8	8.3	1.8	-4.5	2.3	3.6	-1.5	-0.3	0.1	0.7	1.0	1.9	
Net non-debt creating capital inflows	2.2	2.1	2.5	1.7	1.8	2.2	0.3	2.0	2.0	2.0	2.0	2.0	2.1	

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.

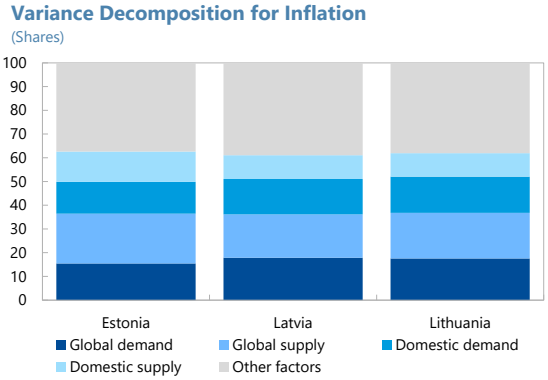
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex V. High Inflation in the Baltics: Inflation Dynamics and Its Impact on Competitiveness and Firm Performance[1]

A. Inflation Dynamics and the Role of Policies

1. After a period of low and stable inflation, the Baltics have experienced a surge in inflation, which remains twice as high as in the rest of the eurozone. The period after the global financial crisis (GFC), when the three countries joined the euro, and before the pandemic was characterized by low and stable inflation with a differential vis-a-vis the euro area broadly consistent with the ongoing convergence process. More recently, prior to Russia's invasion of Ukraine, the robust post-pandemic recovery resulted in demand-driven inflationary pressures compounded by supply bottlenecks. The war in Ukraine has generated further supply-side pressures and contributed to second-round effects—intensified by tight labor markets—due to higher wages and production costs. These factors pushed inflation above 20 percent in 2022 and are projected to keep it at an elevated level relative to the euro area for the foreseeable future.

2. Inflation in the Baltics is mainly driven by global factors, but domestic demand matters as well, suggesting that fiscal policy can play a role in containing inflation. Furthermore, while global supply factors do not seem to have an immediate significant impact on wage growth in the Baltics, demand shocks (domestic and global) have a positive and significant impact. Using sign restrictions in a structural vector autoregression model to identify supply and demand factors, we find that about 37 percent of the variance of inflation is explained by global factors (demand and supply). A 5 percentage point increase in oil prices increases inflation in the Baltics by around 0.3-0.4 percentage points (0.1 percentage points in the euro area) and leads to a 0.7-0.8 percentage point contraction in output (0.5 percentage points in the euro area as a whole). Notably, the impact on wage growth is not statistically significant in Estonia and Latvia. However, the oil price shock leads to a 1 percentage point decline in wage growth in Lithuania after the third quarter. While domestic factors (demand and supply) only explain about 25 percent of the variance of inflation, these shocks have a significant impact on inflation. A one standard deviation shock to domestic real GDP—around 0.7-0.8 percentage points of growth in the Baltics and 0.6 percentage points in the euro area—, increases inflation by around 0.3-0.4 percentage points in the Baltics, well above the 0.1 percentage point impact in the euro area. Thus, through its impact on domestic demand, fiscal policy can affect inflation. A domestic demand shock has an impact on wage growth in Estonia (1 percentage point) and



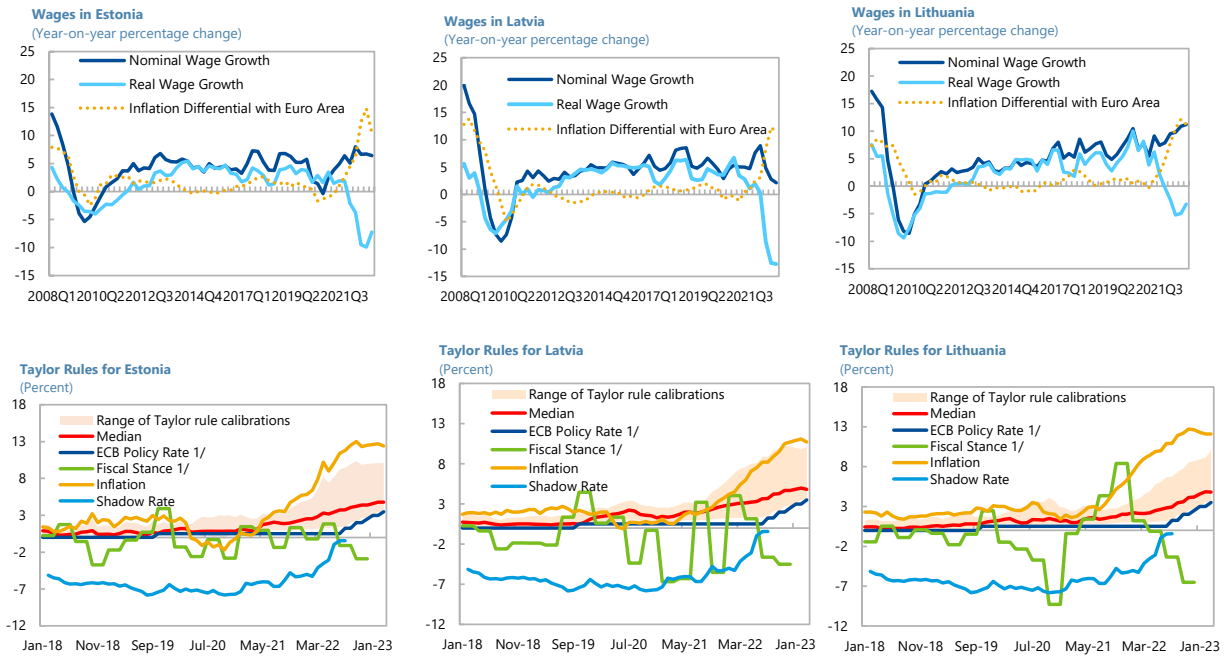
Source: IMF staff calculations.

[1] Cevik, S., A. Fan, B. Hu, S. Naik, N. Noumon, and K. Primus (*forthcoming*). "High Inflation in the Baltics: Disentangling Inflation Dynamics and Its Impact on Competitiveness and Firm Performance," IMF Working Paper.

the euro area (0.4 percentage points). Similarly, global demand shocks have a significant positive impact on wage growth in the Baltics (1 percentage point) and euro area (0.5 percentage points).

3. Monetary conditions have tightened recently in response to rising inflation, but fiscal policy—the only macroeconomic stabilization tool available in the Baltics—has not done enough. Given the small share of the Baltic economies in euro area GDP, ECB monetary policy cannot fully respond to specific conditions in these small open economies. As a consequence, over the last few years, monetary tightening came late from the perspective of the Baltic region—starting more than a year after inflation began to pick up—leaving the monetary policy stance too loose relative to domestic economic conditions. Thus, the onus to contain inflationary pressures partly lies with fiscal policy. While the fiscal stance was largely countercyclical before and throughout the pandemic, more recently it has not done enough to contain inflation, particularly in Estonia and Lithuania where the fiscal stance is expected to loosen this year.

Annex V. Figure 1: Baltics: Monetary and Fiscal Policy Stance



Source: European Central Bank; Haver Analytics; and IMF staff calculations.
1/ ECB policy rate is the main refinancing operation rate and fiscal stance is calculated as the year-on-year difference in cyclically adjusted primary balance in percent of potential GDP.
Note: The range of Taylor rates includes calibrated interest rates obtained from an adjusted Taylor rule of the type $i = r^*+\pi^* + a(\pi-\pi^*) + b(y-y^*)$ with different values for the parameters a and b, and inertial rules with smoothing, where the calibrated rate in the current period depends on the policy rate in the previous period, i.e.: $i = c^*i(-1)+(1-c)^*[r^*+\pi^* + a(\pi-\pi^*) + b(y-y^*)]$. Core HICP inflation is used in all calibrations while economic slack is measured using detrended unemployment (the unemployment gap).

4. Fiscal policy plays a relevant role in containing inflation through its impact on domestic demand. Using an augmented Phillips curve with fiscal variables, we find that an increase of one percentage point of (potential) GDP in the cyclically adjusted primary balance is associated with an

increase in inflation of around 0.3-0.4 percentage points in the Baltics.[2] A VAR framework delivers consistent results—a 0.3-0.75 percentage points increase in inflation—although, in this case, the result is not statistically significant for Lithuania. These findings are consistent with Chapter 2 of the IMF Fiscal Monitor, April 2023, where, using a Bayesian panel VAR of 17 advanced economies between 1985-2019, the authors found that a one percent of GDP increase in fiscal spending leads to a 0.5 percentage point increase in inflation, with the effect dissipating over 3 to 4 years. While this result is larger than our finding using a Phillips curve framework, their sample includes bigger and less open economies than the Baltics that, therefore, suffer smaller leakage effects of fiscal policy.

B. Inflation, Wages, and Competitiveness

5. Persistently high inflation and wage growth in the Baltics could put competitiveness and income convergence with the euro area at risk. The strong policy response to the large pre-GFC imbalances through fiscal consolidation and nominal wage reductions boosted competitiveness in the Baltics and set the stage for an export boom. Although real wages have increased significantly since 2013, large productivity gains supported the competitiveness of the tradeable sector. Thus, while the real effective exchange rate has steadily appreciated since the GFC, current accounts have remained strong over the same period. However, going forward, persistently higher inflation than in the euro area above what would be justified by productivity gains, could make inflation expectations adjust upwards, perpetuating large increases in price and wages. This would erode competitiveness and slow income convergence. A loose policy mix, particularly in Estonia and Lithuania, and tight labor markets have exacerbated these risks.

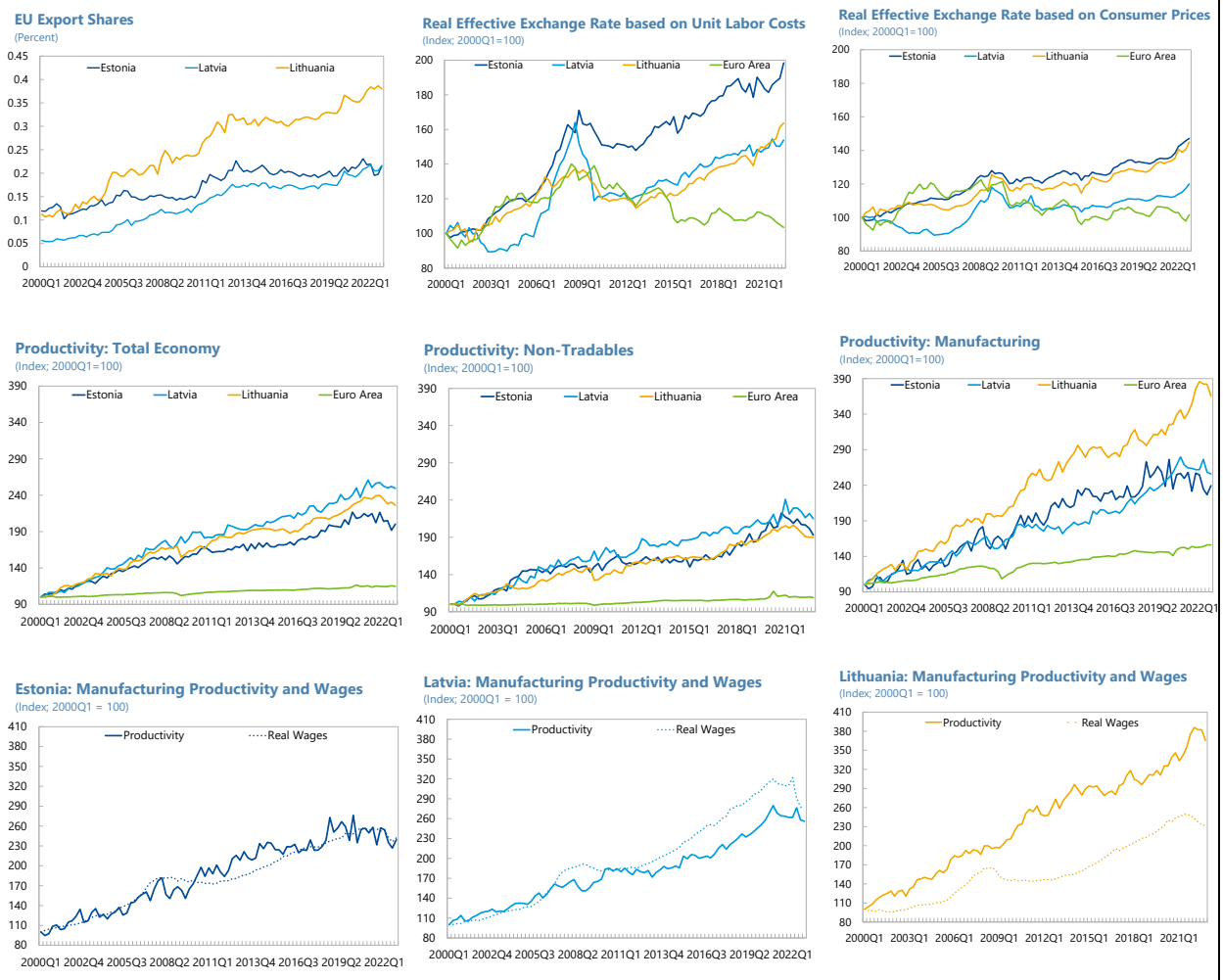
6. There is a close long-term relationship between real wages and productivity in the three countries with short-term deviations self-correcting in Estonia and Lithuania. Co-integration tests confirm that labor productivity and real wages co-move in the three Baltic economies over the longer horizon. The estimated long-run relationship suggests that a one percent increase in labor productivity is associated with an increase in real wages of about 0.8, 0.9, and 1.3 percent in Lithuania, Estonia, and Latvia respectively. Thus, while wage growth is, in the longer-term, slightly below productivity growth in Lithuania and Estonia, it exceeds it in Latvia. This relationship strengthened post-GFC in Lithuania, but it is robust over the whole sample period (2000-2022) for Estonia. Regarding short-term deviations, the speed of reversion to the long-run relationship is estimated to be faster for Estonia (about 3 quarters) than for Lithuania (6 quarters). On the other hand, there is no significant evidence that short-term deviations are self-correcting in Latvia.

7. The close relationship between wages and productivity in the Baltics and the apparent lack of a self-correcting mechanism in Latvia can be explained by differences in labor markets. Estonia has the most flexible labor market in the Baltics as proxied by employment protection

[2] Adding fiscal policy variables in this context raises concerns of endogeneity. However, the use of quarterly data should, as argued by Blanchard and Perotti (2002), largely mitigate this concern given the lags, realistically beyond three months, between approving discretionary fiscal policy measures and their actual implementation. Similarly, collinearity between the output gap and the CAPB could reduce the significance of the estimated coefficients as they explain some of the same variance. However, given the relatively low correlation between the two—around -0.3—and that all estimates of the CAPB are statistically significant, this issue should not be a big concern.

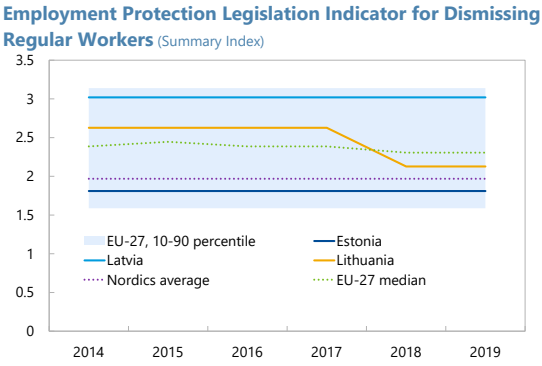
legislations (EPL) underpinned by early reforms (2009-2010). Lithuania follows closely, having made improvements with an important reform of the labor code in 2017-18. Latvia has the least flexible market, with EPLs among the most stringent in Europe and no recent reform efforts. Flexible labor markets result in wages largely determined at the firm-level rather than the industry-level. This is supported by the small share of workers covered by collective bargaining in the region. Flexibility to adjust to the economic cycle is also evident in employers' perceived labor market shortages, which tend to be lower than the EU average during downturn and higher during expansions.

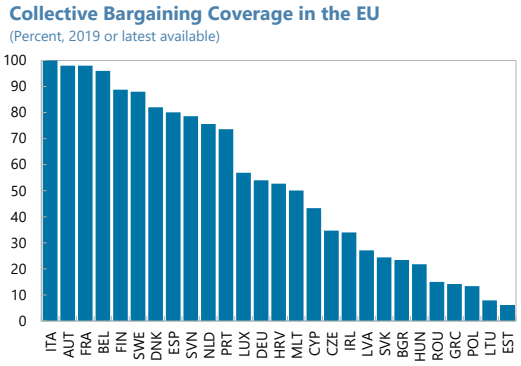
Annex V. Figure 2: Exports Share, Competitiveness, and Labor Productivity Wage-Productivity Nexus

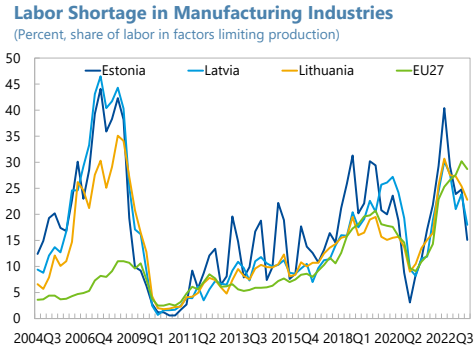


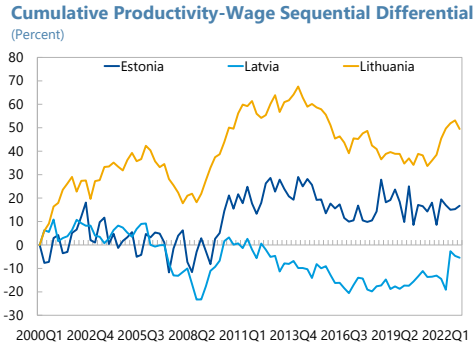
Sources: Eurostat; IFS; Haver Analytics and IMF staff calculations.

Annex V. Figure 3: The Role of the Labor Market









Source: OECD; European Commission; Eurostat; Haver Analytics; and IMF staff calculations.

C. Inflation and Nonfinancial Firm Performance

8. In the past, firm level data suggest that temporary inflation shocks—likely linked to increases in demand—have had a small, transitory positive impact on profitability and investment. Given the negative impact of inflation surprises on real wages, firms' profitability increases in the short-term supporting higher investment that is followed by higher productivity going forward. These are the findings of an analysis based on an unbalanced panel of more than one hundred thousand firms from the Baltics. These results seem to be driven by firms in the tradable sector, with non-tradable firms' responses being statistically insignificant.

9. However, depending on the circumstances, persistent bouts of inflation could have negative effects on investment and productivity. The results suggest, that during expansionary periods, the impact on profitability is positive but transitory with a longer-lasting increase in investment. On the other hand, during contractionary periods, an inflation shock decreases profitability which, over time, has a negative impact on investment. Moreover, the sample period, 1997-2021, is one of low and stable inflation (particularly since the GFC).[3] This suggests that the inflation shocks analyzed

[3] One standard deviation inflation shock was equal to 2.5 percent during the sample period, compared to as much as 25 percent recorded in 2022.

here are moderate demand shocks unlike those in high and volatile inflation cases that have been found to have significant detrimental effects on firms' performance in the literature.[4]

D. Some Policy Considerations

10. High and persistent inflation is the biggest risk facing the Baltic economies and fiscal policy can proactively reduce this risk. Supply shocks present a difficult tradeoff to policy makers that are called to opt between containing inflation or supporting activity. Given the balance of risks and the impact of fiscal policy on inflation through its effect on domestic demand, a tighter fiscal stance would actively contribute to lower inflation in the current context.

11. Structural policies such as setting moderate minimum and public sector wages can also help mitigate the risk of higher wage growth. This is the case given their important role as a reference in private sector wage negotiations. It also makes inflation expectations less backwards looking.

12. Short-term deviations of wages from productivity can be absorbed in Estonia and Lithuania provided they are temporary but not in Latvia where risks are higher. With wage growth in tradables below productivity growth in equilibrium and with short-term deviations self-correcting over time, the long-term impact of deviations of wages from productivity in the current high inflationary environment should be limited for Estonia and Lithuania. With wage growth already above productivity growth in equilibrium and no significant self-correcting mechanism to rectify short-term deviations for Latvia, the long-term impact of the current environment can be long-lasting, especially if further inflation risks materialized. This reinforces the role of fiscal policy in containing inflationary risks.

13. The lack of macroeconomic imbalances, flexible labor markets and the strong competitive position provide some comfort that these economies will be able to absorb the current shock. This is in sharp contrast to the situation in 2008 when large imbalances triggered increasingly unsustainable macro dynamics. On the other hand, the lower labor market flexibility in Latvia may have an impact on the economy's competitiveness and its capacity to absorb shocks compared to the other Baltic economies.

[4] See, for example, Banerjee, Cockerell, and Russell (2001), Mishkin (2007), and Bhattacharjee and others (2008).

Annex VI. Concentration and Profitability in the Banking Sector

1. The Banking system in Lithuania is highly concentrated. At end 2022 there were 13 banks and 6 foreign branches operating in Lithuania (up from 7 and 9 in 2018) with the three largest banks accounting for 70 percent of system assets (down from 84 percent in 2018). While this level of concentration is high for Europe, it is not for small economies like Lithuania. The high level of concentration has not resulted in poor competition. The traditional H-Statistic that attempts to capture monopolistic behavior by assessing the changes of output prices in response to changes in input prices, is among the highest in Europe (IMF Country Report No. 19/252, 2019).

2. There is a healthy level of profitability. Return on assets was 0.95 on average over the period 2012-2021 and return on equity around 10. These levels of profitability are among the highest in Europe with an average of 0.57 and 5.9 percent return on assets and equity respectively. However, profitability in Europe fell dramatically after the GFC with an average return on equity around 13 percent pre-crisis versus 3 percent afterwards. Thus, Lithuania's profitability is more consistent with sustainable, healthy, levels of profitability that are key to ensure a resilient banking system that can provide credit and financial services in support of the economy. A useful benchmark in this regard is the ex-post return on equity being above the ex-ante cost of equity capital (i.e., the return that shareholders require). While the market-implied cost of equity varies over time, the median for each region in the world has ranged from 8 to 14 percent since 2013, consistent with the level observed in Lithuania (GFSR, April 2020, Ch. 4, IMF).

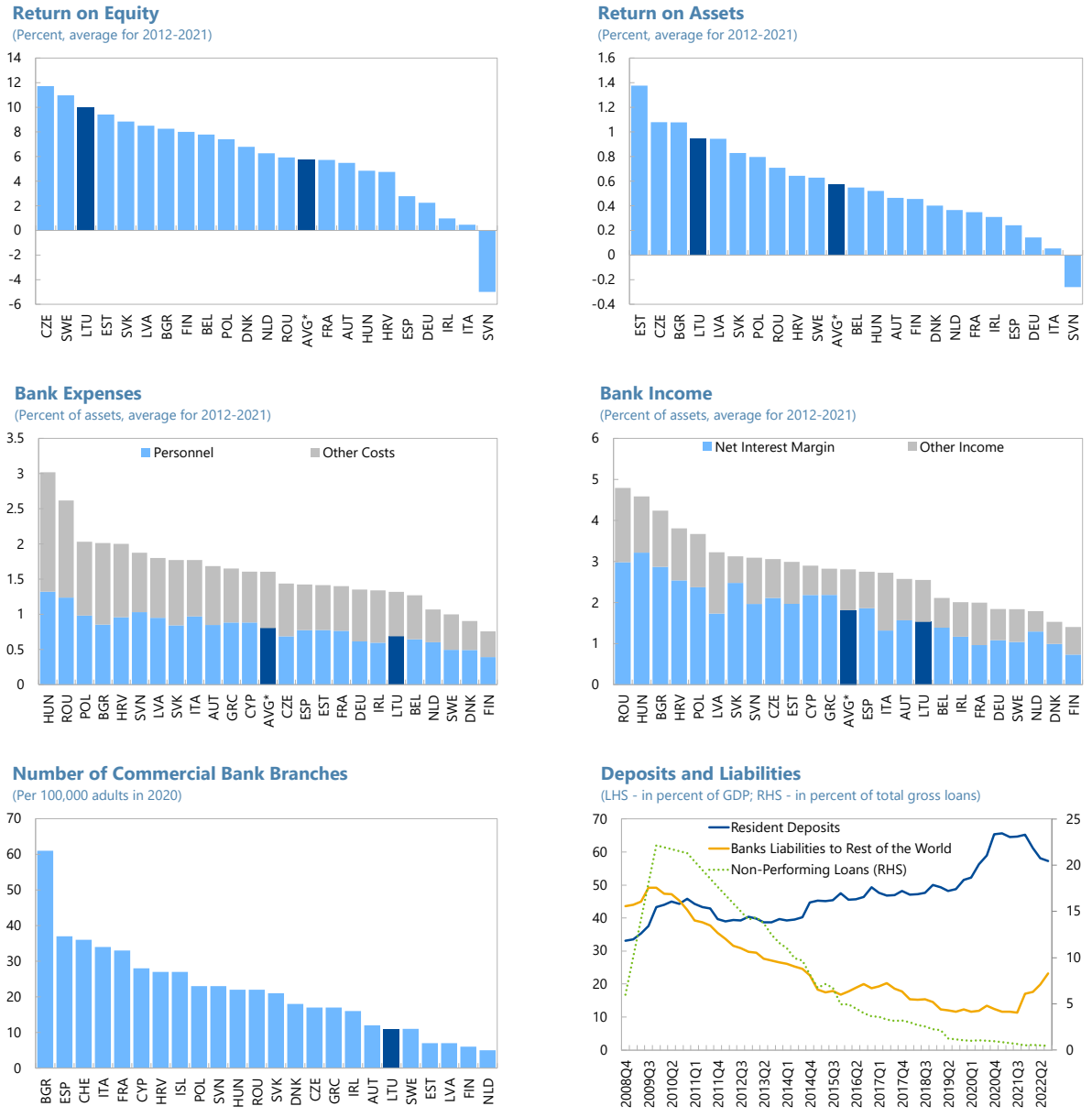
3. Banks profitability is largely driven by efficiency. While cost-to-income ratios are among the most efficient in Europe, net interest margins are below the European average (see figure). Low cost (measured in percent of total assets) is driven by both personnel and non-personnel expenses as reflected, for example, in having one of the lowest number of branches per capita in Europe as well as a below average share of employment relative to total employment. Lithuania banks successfully cleaned their balance sheets from nonperforming loans much faster than other countries in Europe (NPLs fell from over 20 percent in 2010 to 7 percent in 2015 and below 1 percent in 2022). Since the GFC they have maintained a low level of NPLs, a strict discipline on costs and had a very large decline of parent funding (mainly wholesale). All these factors have been found to have a positive impact on profitability and keep net interest margin broadly stable over the financial cycle.[1]

4. There are signs that competition, particularly on the payments side, is increasing. While the system remains highly concentrated, the number of participants is increasing. This, however, will not immediately translate into higher competition on the lending side as new banks are very small and/or their business model—largely based on nonresident European clients—target segments of the market not being covered by established banks. On the payments side, new fintech participants are already increasing competition with banks. However, in times of heightened

[1] Where Have All the Profits Gone? European Banks Profitability Over the Financial Cycle, Detragiache et al, IMF WP/18/99

uncertainty, traditional well-established, well-managed banks benefit from the perception of being safe, low risk as reflected in the large increase in deposits during covid and after the war in Ukraine.

Annex VI. Figure 1: Lithuania: Banking Sector Performance



Source: ECB; Haver Analytics; Financial Access Survey, IMF; Bank of Lithuania; and IMF staff calculations.
Note: Averages indicate average of the sample shown.

Annex VII. Government's New Tax Reform Proposal

1. Real estate taxes: currently applied to high-value properties. The reform imposes the tax on properties valued above 1.5 times the median in each municipality exempting more than the bottom half of residential real estate. The annual tax rate would be 0.06 percent on properties worth between one and a half and two times the median value and 0.1 percent on properties above that threshold. Retired and socially vulnerable people could apply to defer the tax until their property is sold or otherwise passed on to new owners. Property tax revenues would be channeled directly to municipalities.

2. Self-employed: the reform proposes two alternative regimes: (i) using a business certificate and (ii) registering as individual activity.

- The business certificate regime—intended for short-term work—would be subject to a cap on annual income at €20,000 (currently at €45,000) and a tax rate of 15 percent (minus deductions) rather than paying a fixed amount of tax. Currently, about 84 percent of self-employed using business certificates earn less than €20,000 per year.

- The individual activity regime—covering mostly high-earners such as lawyers—would increase in the income tax rate from 15 percent to 17 percent in 2025 and to 20 percent in 2026. Currently, employment income is subject to a tax rate of 20 percent, with the higher marginal rate of 32 percent applied to earnings above €101,100 per year, passive income (i.e., interest earnings and rental income) are taxed at 15 percent. The proposed reform would tax all types of income at 20 percent by 2026 and apply an additional marginal tax of 5 percent on earnings above €101,100 and 7 percent on earnings in excess of €303,300 euros per year. About 16,500 taxpayers would be subject to the higher income tax rates (up from around 8,000), or 0.8 percent of all taxpayers in the country.

Fiscal Impact of the Initial Tax Review Package Proposal, 2026
(in EUR million)

Item	Value	% of 2022 GDP
"Green package": changes in excise duty taxation	172.9	0.26
"Green package": introduction of the CO2 component	120	0.18
Review of taxation of revenue from self-employement	84	0.13
Review of application of progressive PIT rates	64	0.10
Changes in taxation of business certificates	30.7	0.05
Review of CIT exemptions (measures which have a positive effect on State budget revenue)	18.7	0.03
Changes in property taxation (varies depending on the rates set by municipalities, lower bound estimate is included in the overall estimate)	from 17 to 115	from 0.03 to 0.17
Unification of taxable base for different types of self-employed	6.5	0.01
Introduction of unemployment insurance contributions for the self-employed	9.8	0.01
Increase of the VAT registration threshold	-7.4	-0.01
Automatization of PIT tax refund requests	-57	-0.09
Discarding of the criteria of number of employees in the definition of small companies for CIT purposes, where a reduced 5% CIT rate and other incentives are applied (keeping just the revenue criteria)	-1.4	0.00
CIT incentive aimed at increasing reinvestment of profits (allowing instant deduction of selected asset categories, fiscal impact in the long-term is neutral)	-85.3	-0.13
Extension of the CIT tax incentive for investment projects	-106	-0.16
Extension of the CIT tax incentive for the film production	-14	-0.02
Total	252.5 to 350.5	0.38 to 0.52

Source: Ministry of Finance

- All self-employed workers would be required to pay social insurance contributions as other workers—calculated on 90 percent of taxable income instead of the existing range of 50 to 100 percent. The maximum amount on which contributions are paid would increase from €64,700 to €101,000 per annum.

3. The tax reform package also includes, among others, (i) increasing annual income threshold for businesses to register as VAT payers from €45,000 to €55,000 in 2024; (ii) reducing the corporate income tax rate to 5 percent for small businesses with annual income up to €300,000 and

no more than 10 employees; and (iii) raising the annual turnover threshold for companies to qualify for faster depreciation of fixed assets from €150,000 to €300,000 and removing the requirement on the number of employees.

Annex VIII. Housing Price Bubbles in Lithuania[1]

1. House prices have experienced an uninterrupted boom in recent years. In Lithuania, following a correction of 43 percent during the global financial crisis, property prices have increased by 140 percent since 2010, thanks to strong income growth and low borrowing costs. The sudden surge in consumer prices after decades of low and stable inflation has forced central banks to tighten monetary policy which will have a direct and indirect impact on the real estate market. We investigate the question of whether property prices in Lithuania are in a bubble territory by using monthly city-level housing prices and employing the recursive unit root test that is designed for empirical identification of asset price bubbles in real time. The empirical analysis is based on a dataset of monthly observations of city-level housing prices in Lithuania during the period 1994–2022. Since identifying bubbles in asset prices require sufficiently long-term data, we use the Ober-Haus apartment price index, which is available for 5 cities (Kaunas, Klaipėda, Panevėžys, Šiauliai and Vilnius) and the national average on a monthly basis from January 1994 to September 2022.[2] We draw the city-specific consumer price index (CPI) and its housing component from Statistics Lithuania to calculate the house price-to-rent ratio at the city level.[3]

2. House prices move into the bubble territory when the rate of increase is no longer related to market fundamentals, mainly rental returns and discount rates. In this context, a double-recursive algorithm enables bubble detection and consistent estimation of the origination and termination dates of bubble episodes while allowing for the presence of multipole structural breaks within the sample period. When the sample includes multiple bubble episodes, the Phillips-Wu-Yu (2011) test may fail to show the existence of bubbles, especially in analyzing long series or rapidly changing data.[4] Accordingly, we use an augmented version of this test, which utilizes a recursive flexible window approach that is more robust in identifying multiple bubbles in time series. The test statistics are significantly greater than the 1 percent critical value. As a result, we reject the null hypothesis of no-bubble and thereby find evidence of explosive behavior in real housing prices across five cities as well as at the national level in Lithuania during the period from January 1994 to September 2022. We also obtain similar results for the house price-to-rent ratio, but this alternative measure of the real estate market shows greater variation in the extent of explosive behavior across cities, partly because of more limited time dimension of the data.

3. Overall, the results indicate that there are long and multiple periods of explosive behavior in real house prices—beyond the level justified by fundamentals—in all major cities during the period 1994–2022. We also observe a similar pattern of exuberance over the sample

[1] This annex is based on S. Cevik and S. Naik, "Bubble Detective: City-Level Analysis of House Price Cycles," IMF Working Paper No. 23/33 (Washington, DC: International Monetary Fund).

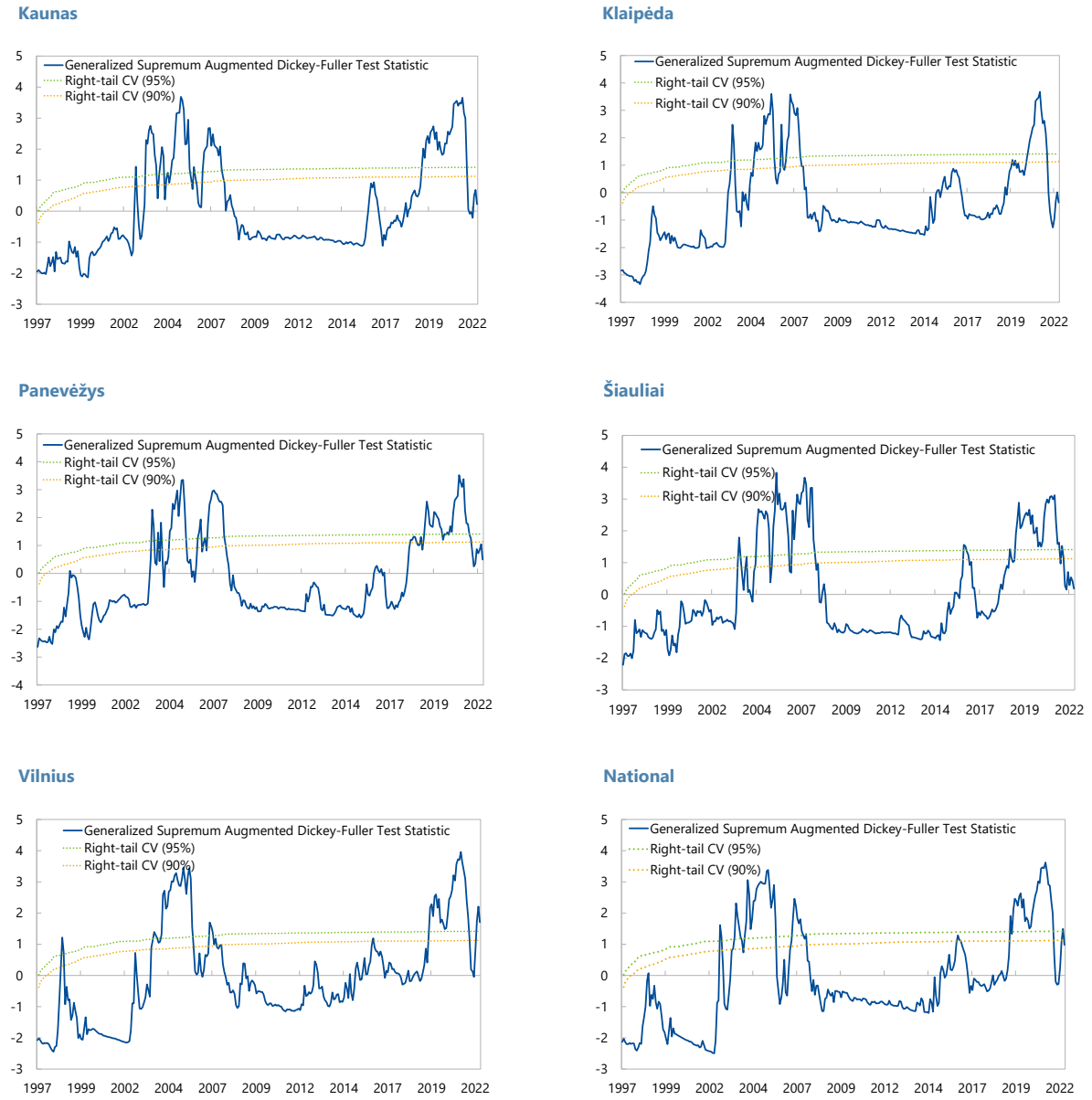
[2] The Ober-Haus price index covers five large cities in Lithuania. Detailed information on the methodology and the latest data are available at https://www.ober-haus.lt/en/rinkos_apzvalgos/lithuanian-price-index/.

[3] The housing component in the city-level CPI series includes rents and utilities. We also use the national CPI data for the rental index and obtain similar results.

[4] Phillips, P., S-P. Shi, and J. Yu (2015). "Testing for Multiple Bubbles: Historical Episodes of Exuberance and Collapse in the S&P 500" *International Economic Review*, Vol. 52, pp. 201–226.

period when we estimate the model with house price-to-rent ratio, but this measure of the real estate market shows no significant bubble in recent years, except in the case of one city. Furthermore, after remaining stable for an extended period after the GFC, house price growth accelerated significantly during the pandemic. All in all, while the size of bubbles varies across cities, especially when we use the house price-to-rent ratio, there is clearly a similar boom-bust pattern throughout the country.

Annex VIII. Figure 1: Explosive Behavior of Real House Prices: Generalized Supremum Augmented Dickey-Fuller Test



Source: IMF staff calculations.
Note: CV indicates critical values.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LITHUANIA

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 18, 2023

Prepared by European Department

CONTENTS

FUND RELATIONS

(As of March 31, 2023)

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)	322.58	73.05
Reserve Tranche Position	119.03	26.96

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	560.49	100.00
Holdings	568.74	101.47

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			
	2023	2024	2025	2026	2027
Principal					
Charges/Interest	-	0.01	0.01	0.01	0.01
Total	-	0.01	0.01	0.01	0.01

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 19 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, Sections 2(a), 3 and 4 of the IMF'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 July 28, 2022. The staff report and other related documents are available at: https://www.imf.org/en/Publications/CR/Issues/2022/07/27/Republic-of-Lithuania-2022-Article-IV-Consultation-Press-Release-and-Staff-Report-521360

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.

Table 1: Lithuania: Technical Assistance from the Fund, 2001–23

Department	Issue	Action	Date	Counterpart
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. 3–15, 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	Value Added Tax Gap	Mission	Oct. 23–Nov. 6, 2019 Feb. 27–Mar. 5, 2020 May 3–Nov. 26, 2021	State Tax Inspectorate
FAD	High Wealth Individuals Management	Mission	Feb. 25–Mar. 30, 2021 May 20–25, 2021 Jul. 28–30, 2021 Jan. 10–20, 2022 Feb. 8–9, 2022 Sep. 26 – Oct. 5 2022	State Tax Inspectorate

Table 1: Lithuania: Technical Assistance from the Fund, 2001–23 (concluded)

Department	Issue	Action	Date	Counterpart
			Nov. 23 – Dec. 9, 2022 Feb. 20 – Mar. 15, 2023 Apr. 7 – Apr. 28, 2023	
LEG	AML/CFT Framework	Mission	May 2–6, 2022 May 25–Jun. 2, 2022	Bank of Lithuania/Financial Intelligence Unit
FAD	Compliance Gap Integration	Mission	Mar. 1 – Apr. 28, 2023	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 2018 MONEYVAL assessment rated Lithuania's AML/CFT regime as insufficiently effective in ten out of eleven pillars of an effective system, including moderate effectiveness of AML/CFT supervision, preventive measures by reporting entities, and ML/TF risk understanding and domestic coordination. Given the results of the assessment, Lithuania was placed in an enhanced follow-up process. Following the MONEYVAL assessment, Lithuania has strengthened its legislative and regulatory framework and taken steps to enhance its AML/CFT effectiveness.

In December 2022 Lithuania's third enhanced follow-up report was adopted, in which the country was re-rated from 'Partially Compliant' to 'Largely Compliant' for two recommendations (Recommendations 24 and 32). For Recommendation 24 on transparency of beneficial ownership of legal persons, the country was upgraded following the establishment of its beneficial ownership register. For Recommendation 32 on cash couriers, the country was upgraded following the development of the necessary legal framework to empower the customs authorities to request and obtain further information where a false declaration or disclosure, or failure to declare, is detected.

The government has established an AML Centre of Excellence, which is designed to facilitate information sharing and strengthen collaboration among key stakeholders. A National Risk Assessment (NRA) was completed in 2019 and the report was published in 2020. Based on the NRA report, a plan for the measures to mitigate the risk of ML/TF for 2021–2023 was prepared 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 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. 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 entered into force on August 1, 2021. Virtual currencies and custodian wallet providers were included into the scope of the AML/CFT Law amendments. Further draft amendments to the AMLCFT law are currently being considered that would address remaining risks in the VASP sector and enhance the regulation and supervision of designated non-financial businesses and professions.

STATISTICAL ISSUES

(As of June 23, 2023)

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 have been revised in accordance with the ESA 2010). 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 2015.

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. 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 (MoF), State Social Insurance Fund Board , 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. In addition, the MoF is reporting quarterly and monthly data for publication in the International Financial Statistics (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 using Euro Area wide and national residency criteria. Data are published in IFS with a lag of about a month. The Bank of Lithuania (BoL) reports some data and indicators of the Financial Access Survey , including two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the United Nations Sustainable Development Goals.

Financial sector surveillance: Lithuania reports 13 core and 5 of the 12 encouraged financial soundness indicators (FSIs) for deposit takers, three FSIs for nonfinancial corporations, two FSI for households, and three 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 (BoP), international investment position (IIP), external debt and international reserves statistics. The BoL reports quarterly data on BoP, IIP and monthly international reserves to STA on a timely and regular basis. BoP 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 BoP 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 three STA initiatives: (i) the Coordinated Direct Investment Survey; and (ii) the Coordinated Portfolio Investment Survey. 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. The BoL disseminates quarterly external debt data in the World Bank's Quarterly External Debt Statistics 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).

Table 2: Lithuania: Common Indicators Required for Surveillance

As of June 21, 2022

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:	
						Data Quality – Methodological soundness[8]	Data Quality – Accuracy and reliability[9]
Exchange Rates	May 2022	June 2022	M	M	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	April2022	June 2022	M	M	M		
Reserve/Base Money	April 2022	June 2022	M	M	M	O, LO, LO, LO	O, O, LO, O, O
Broad Money	April 2022	June 2022	M	M	M		
Central Bank Balance Sheet	April 2022	June 2022	M	M	M		
Consolidated Balance Sheet of the Banking System	April 2022	June 2022	M	M	M		
Interest Rates[2]	April 2022	June 2022	M	M	M		
Consumer Price Index	May 2022	June 2022	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2021Q4	June 2022	Q	Q	Q	LO, LO, LO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	2021Q4	June 2022	Q	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	April 2022	June 2022	M	M	M		
External Current Account Balance	2021Q4	April 2022	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	2021Q4	April 2022	Q	Q	Q		
GDP/GNP	2022Q1	June 2022	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]	2021Q4	April 2022	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 Vitas Vasiliauskas, Executive Director for the Republic of Lithuania and Raido Kraavik, Advisor to the Executive Director
August 28, 2023

On behalf of the Lithuanian authorities, we would like to thank staff for the productive and candid policy discussions during the Article IV mission, as well as the comprehensive and well-balanced staff report. Our authorities express their deep appreciation for the mission chief Mr. Gracia who has led his last mission to Lithuania. The advice and insight of Mr. Gracia and his team have been truly trusted and highly valued in Lithuania. The authorities agree with the thrust of staff's findings and recommendations, which are broadly in line with their own assessment and policy priorities.

Recent Economic Developments, Outlook, and Risks

Russia's illegal and unjustified war against Ukraine has weighed on economic activity. Output contracted in the fourth quarter last year and the first quarter this year. A decrease in the manufacturing sector's value added had the largest impact on the weakened economic activity, as manufacturers had to adjust their supply chains and cope with the surge in energy prices, as well as weaker external demand. At the same time, the surge in inflation reduced real household income and curbed private consumption.

However, the economy is showing resilience, with the latest data releases surprising on the upside after a transitory contraction of activity. The output grew by 2.8 percent q-o-q and 0.9 percent y-o-y in the second quarter of 2023, according to preliminary estimates. The economic activity was stimulated by the construction sector, partly supported by public investment, including an increased use of the EU funds and investments in renewable energy. As the energy price shock subsides, the manufacturing activity has also increased, although clear signs of a sustained recovery in the sector are yet to emerge. Correspondingly, the labor market is also showing strong resilience, with the unemployment rate decreasing by 1.8 percentage point q-o-q to 5.9 percent in Q2 this year, and the employment rate remaining close to historical highs.

Price pressures continue to subside with the price level decreasing for three months in a row. The annual inflation decreased to 7.2 percent in July, with monthly deflation (0.2 percent in July) recorded for a third consecutive month. After 10 months of rapid disinflation, the annual inflation is expected to continue to decline further and be slightly below 3 percent at the end of the year. The decline will be driven by subsiding energy, food, and other commodity prices, as well as decreasing costs of transportation by intermodal containers. With increasing levels of gas storages in the EU, as well as a rapid scale-up in renewable energy production in Lithuania, the risk of renewed pressures on energy prices has decreased, although the European gas prices have risen in August. The authorities do not expect an emergence of the wage-price spiral in Lithuania, as wage growth remains broadly in line with the observed tensions in the labor market. Both the Bank of Lithuania and the Ministry of Finance expect that the wage growth will slow in 2023. The authorities expect the minimum wage increases to have a marginal impact on inflation.

The authorities expect moderate economic growth in the coming quarters, backed by the resilience of the labor market, increasing household purchasing power amid disinflation and continued wage growth, public investment backed by the EU funding, and the improving outlook of the external trade partners. However, the outlook is surrounded by uncertainty, primarily caused by Russia's war against Ukraine. Stronger than expected impact of tightening monetary policy on the economies of

major trading partners also poses a risk to the outlook. On the upside, decreased uncertainty, coupled with the growing household purchasing power, could lead to faster-than-expected output growth.

The authorities recognize that if a higher than usual inflation differential with the euro area persists, there is a risk of a temporary negative effect on the competitiveness of the economy. Such an effect would be expected to be temporary due to the proved resilience and adjustment capacity of the tradables sector, where real wage gains have been closely anchored with the productivity developments. From 2015 to 2022, labor productivity increased by around 43 percent, the market share of global exports rose by 54 percent, while real wages increased by around 34 percent in the tradable sector. Recently, wage growth in the manufacturing sector has slowed down and now is among the lowest in the economy (10.4 percent in 2023 Q1), thus indicating that the sector is already undergoing some adjustment.

The Bank of Lithuania considers that the evidence on the monetary conditions in Lithuania being too loose is not conclusive and not easily measurable, not least due to Lithuania still being a converging euro area member state with very rapid income growth. The calculation of the appropriate monetary conditions requires accurate and up-to-date data that is often unavailable, as well as making numerous assumptions that are particularly ambiguous for countries belonging to the monetary union. The comparison with the unobserved estimate of a natural rate and / or a shadow rate is also a highly complex exercise.

The Lithuania's economic and energy links with Russia have decreased further since the start of Russia's full-scale war against Ukraine last year. In the first 5 months of 2023, only 0.43 percent of all Lithuanian origin exports were directed to Russia (the share stood at 1.7 percent in 2021), which limits the negative impact of Western sanctions against Russia and countersanctions on the Lithuanian economy. In May last year, Lithuania completely cut the import of Russian energy supplies, i.e., oil, electricity, and natural gas, marking an important step towards energy independence.

Fiscal policy

The authorities reiterate their commitment to prudent fiscal policy as reflected in the domestic fiscal rule that is set to become operational again next year. With debt below 40 percent of GDP – among the lowest in the EU – Lithuania retains ample fiscal space to react to future shocks. The fiscal policy stance this year is expected to be slightly expansionary and countercyclical. The gradual pace of fiscal adjustment going forward strikes a balance between facilitating disinflation and supporting growth.

Energy support measures for both households and businesses have been gradually withdrawn. The partial subsidy on the electricity price for businesses has been terminated. For households, the electricity support scheme has been discontinued, with gas subsidies terminating in end-2023. The reduced need for government funds for the energy price-related measures is one of the main factors behind the projected decrease in the general government deficit for 2023.

The proposed tax reform is an important step towards a better-balanced tax system that supports growth while ensuring enhanced social fairness. The package responds to some of the key recommendations made over the years by the international organizations, including the IMF, such as broadening the tax base and addressing the complexity of the various forms of economic activity. Among the measures in the package aimed at stimulating growth is the immediate depreciation deductions for fixed assets to encourage productive investments and the increase in the annual income threshold for

businesses to register as VAT payers. The reform will also expand the scope of real estate tax by introducing the change of the model on taxation of non-commercial immovable property owned by individuals. The tax reform will also introduce more consistent progressivity on high-income earners and bring the taxation of the self-employed closer to the taxation of income from a standard employment relationship, thus broadening the coverage of social security guarantees, while mostly affecting high-income earners. Finally, one of the key initiatives is the proposed investment account instrument, among the most ambitious in the region, aimed at simplifying the taxation of retail investment income, including taxing profits only when withdrawn from the investment account. It is also worth mentioning that changes to excise duties that support the green transition had been adopted (described in more detail below). The Bank of Lithuania considers the reform to be a step in the right direction, but stresses that further revenue-generating measures will be needed going forward.

Financial sector policies

Ample buffers in the banking sector provide stability, strengthened by extraordinary rise in banks' profitability and proactive macroprudential actions. Risks to financial stability are currently elevated due to high inflation, rising interest rates, and sluggish trade growth. They could materialize through a worsening of household and corporate financial health, as well as corrections in real estate markets. However, households and corporates have shown resilience to shocks so far and, if risks materialize, ample capital buffers should mitigate the negative impact on the financial sector. Macroprudential policy changes, such as the increases of the sectoral systemic risk buffer (sSyRB) rate to 2 percent for the housing loan portfolios and the CCyB rate to 1 percent, help maintain the resilience of credit institutions. The projected high profitability of the banking sector will help strengthen the capital buffers further.

The solidarity contribution on credit institutions is temporary (to be applied through December 2024) and has been designed to avoid distortions and negative effects on financial stability. For 2023, excluding the solidarity contribution, the bank profits were expected to be three times higher than the usual level, which historically has been among the highest in the euro area. In the context of a highly concentrated financial system, only a part of the unexpected net interest income is targeted (exceeding the average of the previous four years by more than 50 percent) and it will contribute to the significantly increased budget needs for national security and military spending. The contribution applies on all credit institutions and existing loans after applying a coefficient of home exposures, and, crucially, excludes income from new lending so as not to distort lending activity to the real economy. Given the unprecedented levels of profitability, post-contribution profits will remain elevated, even with the recent increases in rates offered for term deposits that are now among the highest in the euro area.

The authorities have taken important steps in addressing risks from the maturing fintech sector and ensuring its further sustainable development. They have finalized the National Development Plan for the Fintech Sector 2023-2028, with the goal of ensuring that the fintech sector continues to mature and helps reduce concentration in the national financial sector, provides access to alternative financing sources for residents and businesses, and creates high-skill jobs. The plan focuses on strengthening cooperation with higher education institutions to train specialists needed in the segment, increasing the clarity of regulatory requirements through engagement with fintech entities, and further fostering the cooperation between public authorities and market participants.

Further strengthening of the AML/CFT framework remains at the forefront of the authorities' agenda. Decisive actions have been taken to increase supervisory resources and strengthen the regulatory framework. Strong progress has been made in the VASP sector by upgrading the regulatory framework and introducing a sectoral risk assessment conducted by the Financial Intelligence Unit.

Several deficiencies identified in the country's 2018 MONEYVAL Mutual Evaluation report in the areas of transparency and beneficial ownership of legal persons and cash couriers have been addressed. Further steps are foreseen to strengthen the AML/CFT regime, in line with the recommendations of the ongoing IMF's regional Nordic-Baltic AML TA project.

Structural policies

The authorities agree that structural challenges include social and regional disparities, a sub-optimal quality of public services, as well as unfavorable demographic trends. The authorities continue to pursue reforms in education and healthcare as well as innovation and green transition. They emphasize the importance of the approval of the civil service reform that will provide greater accountability, efficiency, and flexibility in the public sector. The green transition and energy independence remain top priorities, with the ambitious goal of renewables (mostly offshore wind and solar) fully covering the domestic electricity demand by 2030. The approved changes in excises, including the increase of rates on fossil fuels, the introduction of excise duty on heating peat and the introduction of a carbon component, will support the green transition. Consolidation of national promotional institutions will increase the public sector's capacities to efficiently channel investment into priority areas, such as the green and digital transitions, thus boosting the resilience and growth potential of the Lithuanian economy.

Final remarks

The authorities emphasize their commitment to multilateralism, **including through the participation in the Fund's financial initiatives**. Lithuania has joined the FTP, the BBAs, the VTAs, and responded to the calls to contribute to the RST and the PRGT with full requested amounts. Lithuania is also actively participating in the coalition of international partners that continue to support Ukraine. Lithuania has joined the G7 and other countries in providing financial assurances, which enabled the IMF's EFF program for Ukraine. The humanitarian, financial, and military aid allocated by Lithuania to support Ukraine already amounts to more than 1.4 percent of GDP.