LITHUANIA

Highlights

- **Domestic demand and exports are underpinning robust growth.** GDP growth accelerated further during the first half of 2017, underpinned by accelerated investment and rising external demand. Private consumption has remained strong, backed by increasing wages and falling unemployment.
- **Lithuania is aiming for clean energy and greater energy independence.** Among other things, the new national energy strategy sets an ambitious goal to make electricity and heat production independent from fossil fuels by 2050, when all the electricity consumed should be generated domestically. At the same time, renewable energy and other clean sources are set to be the primary source in electricity.
- **The recently approved labour code is expected to boost labour productivity.** In the new legislation labour relations have been made more flexible and the expanded unemployment benefits system now better supports income security.

Key priorities for 2018

- **Full OECD membership is expected in mid-2018.** However, before full accession to the OECD is to materialise, Lithuania still needs to improve its land sale procedures, to reform state-owned forestry and road maintenance companies, and to continue efforts to fight corruption.
- **EU funds absorption needs to improve.** The preparation and presentation of documentation, specifically the guidelines on eligibility criteria, should be shortened and simplified as these are the main reasons for delays.
- **The innovation promotion system requires consolidation.** Its high fragmentation and the narrow focus of each of the advisory and implementation institutions make it difficult to navigate and keep administrative costs high. According to the *European Innovation Scoreboard 2017*, Lithuania largely underperforms in exports of high-tech goods and services, attractive research systems and patent applications.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	3.5	3.5	2.0	2.3	3.6
Inflation (average)	1.2	0.2	-0.7	0.7	3.6
Government balance/GDP	-2.6	-0.6	-0.2	0.3	0.1
Current account balance/GDP	0.8	3.2	-2.8	-1.1	-1.5
Net FDI/GDP [neg. sign = inflows]	0.6	0.0	-1.9	-0.4	-2.0
External debt/GDP	70.4	69.9	75.7	85.6	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	42.8	40.5	41.3	42.9	n.a.

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Macroeconomic performance

Strong private consumption has supported GDP growth. Following a deceleration to 2.0 per cent in 2015, economic growth accelerated to 2.3 per cent in 2016 and further to 4.1 per cent year-on-year in the first half of 2017. Private consumption, supported by rising wages and consumer lending, was the key growth driver, but its leading positive impact on GDP growth has been somewhat mitigated by recovering investment and export demand. Strong export growth was particularly registered in low value-added manufacturing, such as furniture and dairy products, but also in high value-added services, which have been constantly growing since 2011.

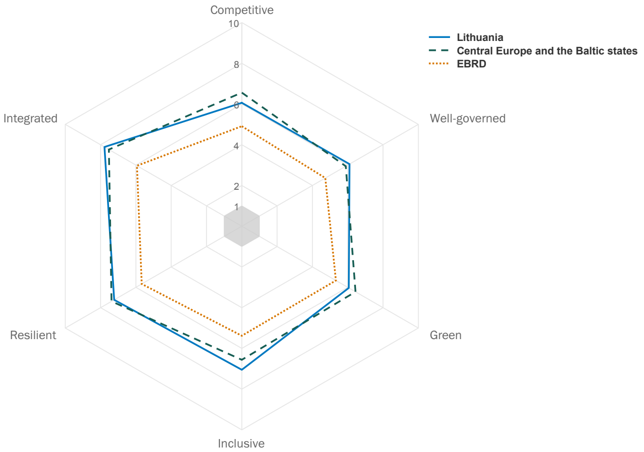
Investment has the potential to rebound sharply. After registering a drop of 0.5 per cent in 2016, investment growth recovered by 5.7 per cent during the first six months of 2017. Some turnaround in EU funds absorption at the beginning of this year has lifted public investment, while the historically high capacity utilisation of Lithuanian companies, amid rising corporate credit, provided a strong push for higher private sector investment. The latter is expected to strengthen further, as rising labour shortages force companies to invest in capacity expansion and technological advancement.

Labour shortages constitute a challenge for Lithuania's international competitiveness. The employment rate exceeded 75.0 per cent in mid-2016, which is the second highest such rate in the central Europe and the Baltic states region, although its further growth has stalled. This slow-down is attributed to the shrinking working-age population and persistent net emigration, which, on the other hand, contributes to high wage pressure and strong competition for experienced staff among companies. Rising salaries, at 8.0 per cent in real terms in 2016, have lifted up unit labour costs, which have been growing faster than productivity since 2012. Such developments may further weigh on Lithuania's export market shares, which have dropped by 12.0 per cent since the Russian sanctions were imposed in 2014.

Public finances saw their first ever surplus in 2016. The 2015 budget deficit of 0.2 per cent of GDP turned into a surplus of 0.3 per cent last year, as strong tax collection was boosted by a buoyant labour market and lower-than-expected fiscal expenditures. However, the expected high costs of labour market reforms, together with an increase in public wages and pensions, are expected to put the public finances back into deficit from this year. According to the European Commission autumn estimates, public debt is expected to reach 41.5 per cent of GDP in 2017 and 37.9 per cent in 2018.

Exports and investment are expected to further boost short-term growth. Lithuania's GDP growth is set to recover further, particularly driven by strengthening investment and external demand, including from Russia. At the same time, robust wage growth will maintain strong private consumption. Overall, GDP growth rates are forecast to reach 3.6 per cent and 3.5 per cent in 2017 and 2018, respectively. Risks to that scenario are lower-than-expected EU funds absorption and weaker-than-anticipated recovery of external demand.

Assessment of transition qualities (1-10)



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Major structural reform developments

Lithuania aims at full electricity production independence by 2050. The new national energy strategy is expected to be approved by the parliament by early 2018. It sets an ambitious goal to make electricity and heat production independent from fossil fuels by 2050, when all the electricity consumed should be generated domestically. The strategy also envisages a link of the country's electricity grid to continental Europe via Poland (the so-called LitPol pipeline) from 2020. Renewable energy and other clean sources are foreseen to be the primary source in the electricity, heating and transport sectors. In 2015, with a share of 25.8 per cent, Lithuania had already achieved its Europe 2020 renewable energy mix target of 23.0 per cent. Biomass and waste represent 92.0 per cent of the renewable energy mix production.

Full OECD membership is expected in 2018. Since the kick-off of the accession process in mid-2015, Lithuania has made significant progress in unifying its legislation with the other OECD countries. Among others, amendments to the VAT law were approved by the government in August 2017, which will allow foreign investors to claim a refund of the value-added tax paid in Lithuania. However, before full accession to the OECD could materialise (now expected in mid-2018), Lithuania still needs to improve its land sale procedures, to reform state-owned forestry and road maintenance companies, and to continue efforts to fight corruption. Once membership is finalised, Lithuania is expected to attract more investment and to further reduce its international borrowing costs, which have already dropped substantially since the country's eurozone accession in 2015.

A modern labour code has been adopted. The new labour code entered into force in July 2017. It is now incorporating amendments agreed in the Tripartite Council. In the new legislation labour relations have been made more flexible and the expanded unemployment benefits system now better supports income security. The new law is an important step towards enhancing competitiveness and the quality of the business environment. Any potential deficiencies should be addressed at a later stage, once the new regulations work in practice.

Low-income households and small businesses will receive government support. The prime minister announced in June 2017 that the government planned to allocate an extra €0.5 billion annually (1.3 per cent of GDP) for social-related purposes. Some extra money should be provided to pensioners and children, including the doubling of child benefits. Also, the non-taxable threshold may be increased to the minimum wage level, with the expectation that the latter is lifted to €500 per month in January 2018, from the current €380. On the business side, all new small companies should be provided with a one-year break from corporate taxes, along with tax breaks from social security contributions.

EU funds absorption is proceeding slowly. Up until mid-2017, only about 15 per cent of the funds available for 2014-20 had been absorbed so far. According to the Ministry of Finance, some €2.14 billion is expected to be allocated by the end of 2017, which is 20 per cent less than initially planned at the beginning of the year. Preparation of measures' documentation, specifically guidelines on eligibility criteria, are listed as the main reasons for the delays, according to the 2017 KPMG *Progress summaries* 2014-2016 report. For the period 2014-20 around €8.4 billion is allocated to Lithuania through three national programmes, of which €726 million is expected to be delivered through the so-called financial instruments.