LITHUANIA

Highlights

- **Gross domestic product (GDP) growth remains solid.** Rising disposable incomes, boosted by higher wages and, to a limited extent, the cut in the labour tax wedge, continue to stimulate consumption, while the accelerated absorption of funds from the European Union (EU) is fuelling investment.
- **Linkages between business and science are strengthening.** The Economy and Innovation Ministry and the European Organisation for Nuclear Research (CERN) have signed an agreement to set up two business incubator centres in Lithuania's two largest cities, Kaunas and Vilnius.
- **Power grid synchronisation is accelerating.** The Lithuanian parliament adopted a law on the synchronisation of the power grid with the continental European system, as well as 14 associated projects to facilitate the process, which should be finalised by 2025.

Key priorities for 2020

- **Enhanced interaction between business and academia should improve innovation.** Business research and development expenditures remain among the lowest, so particular efforts should be made to capitalise on the recent establishment of the two CERN technology centres to promote innovation among businesses in Lithuania.
- **Fintech and technology-focused innovative solutions should be fostered.** At the same time, the associated risks need to be addressed by enhanced supervisory capacity and strengthened anti-money laundering safety measures.
- **Skill mismatches and adverse demographic changes need to be tackled.** Upskilling the labour force, increasing employment among people with disabilities and introducing smart migration policies are all necessary to counteract unfavourable labour supply trends.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	2.0	2.6	4.2	3.6	3.6
Inflation (average)	-0.7	0.7	3.7	2.5	2.3
Government balance/GDP	-0.3	0.2	0.5	0.6	0.7
Current account balance/GDP	-2.4	-1.1	0.5	0.3	1.2
Net FDI/GDP [neg. sign = inflows]	-1.7	-0.9	-2.0	-0.8	-1.0
External debt/GDP	76.8	86.2	82.6	81.5	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	41.4	42.7	41.0	40.7	n.a.

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Macroeconomic performance

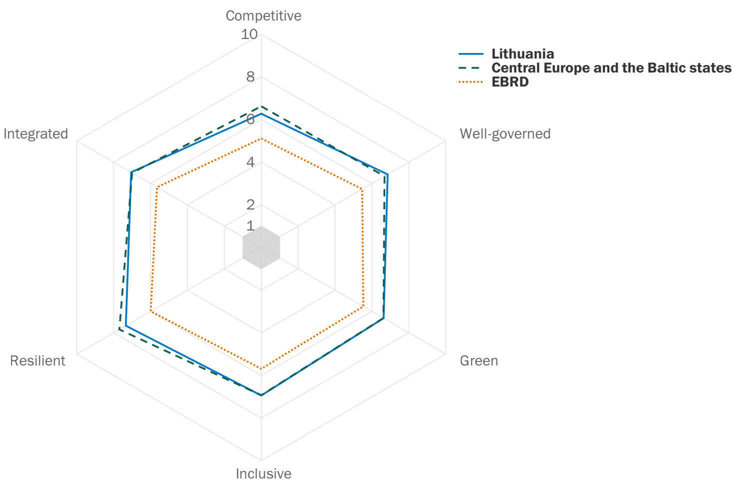
The economic expansion remains robust. GDP growth, at 3.5 per cent in 2018 and 4.1 per cent year-on-year in the first half of 2019, continues to be supported by vibrant household consumption, investment and exports. Recent labour tax reforms have effectively reduced the tax wedge in 2019 and, amid rising wages and low unemployment rates, have provided an additional boost to household spending. Investment growth is strong as a result of better utilisation of EU funds. Net exports have also positively contributed to growth, especially in the first half of 2019, despite the weaker external environment and a strong base effect.

Investment continues to be the critical engine of GDP growth. In 2018, investment grew by 6.5 per cent, and then accelerated to 8.2 per cent year-on-year in the first half of 2019. The improved utilisation of EU funds (66.0 per cent of the funds already allocated at the end of 2018), greater investments in automation by corporates and a positive business sentiment were the key factors in explaining strong investment performance. By contrast, increases in bank lending to non-financial corporates started to decline in the middle of 2018, before coming to a halt in June 2019. This temporary slowdown is largely due to financial imbalances in the Nordic countries, where the headquarters of some parent banks of major Lithuanian banks are located, along with the money laundering scandals that have occurred in all three Baltic states recently.

Public finances saw surpluses for three years in a row. In 2018, the general government balance remained in surplus, at 0.6 per cent of GDP. The structural fiscal position stayed broadly neutral and the achieved surpluses resulted from the better-than-expected economic environment. The government balance is estimated to reach a surplus of 0.7 per cent of GDP in 2019, before it balances in 2020. The pre-financing of 2020 bond redemptions are expected to hit government debt in 2019, which is expected to reach 37.0 per cent of GDP by the end of the year, 2.8 percentage points higher than in the previous year.

Structural factors and demographics are the main risks over the medium term. In the short term, GDP growth is expected to reach 3.6 per cent in 2019 and 2.3 per cent in 2020. Domestic demand will likely remain the key growth engine, driven by strong household consumption and investment, as companies continue to invest in automation amid mounting labour shortages. Greater investment in productivity could partially offset negative demographic trends associated with ageing and emigration.

Assessment of transition qualities (1-10)



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Major structural reform developments

Power grid synchronisation is accelerating. In July 2019, the parliament adopted a law on the synchronisation of the power grid with the continental European system, which, among other effects, will facilitate conditions for land acquisition. In August 2019, the government approved a list of 14 projects, such as the expansion of LitPol power interconnection and the reconstruction of the electricity transmission line between the Lithuanian power plant and Vilnius, which all were granted the status of national importance. In January 2019, the European Commission approved €323 million of financing for the first stage of the grids' synchronisation. The disconnection from the Russian BRELL network (the energy ring linking Belarus, Russia, Estonia, Latvia and Lithuania) and full synchronisation with the continental European system is expected to be completed by 2025.

Lithuania has applied to join the International Energy Agency (IEA). Following acceptance from the IEA's governing board of Lithuania's membership application in June 2019, the accession process will likely start at the end of 2019. As a member, Lithuania will be able to benefit from the experience of advanced economies and actively shape energy, environment and climate-related policies with the other 30 members of the organisation. The process of becoming an IEA member typically takes from two to five years.

Immigration rules are being relaxed to boost labour supply. In April 2019, the government proposed a law introducing quotas for third-country nationals coming to work in Lithuania. These quotas should enter into force in 2021 and be set annually by the Employment Service in response to labour market needs. Highly skilled workers will be exempted from those quotas. Also, citizens of the most economically strong countries who do not require a visa to travel to Lithuania will be easily granted temporary residence permits for up to three years, and will be allowed to bring their families with them. Amid shrinking demographics and mounting labour market shortages, these measures are designed to mitigate the impact of labour supply constraints on Lithuania's competitiveness and growth potential.

The size of the shadow economy is being addressed. In June 2019, the government adopted a set of measures to reduce the shadow economy in the construction, meat and car sectors. The size of the grey economy in these three sectors is estimated by the government at €800 million, with the greatest contribution coming from the construction sector. For the latter, the plan envisages the introduction of mandatory identity cards for builders and a related information system. According to the Shadow Economy Index for the Baltic countries, produced annually by the Stockholm School of Economics, the extent of the shadow economy in Lithuania is 18.7 per cent of GDP in 2018, above Estonia (16.7 per cent) and below Latvia (24.2 per cent).

Linkages between business and science are strengthening. In July 2019, CERN signed an agreement to set up two business incubator centres in Lithuania's two largest cities, Kaunas and Vilnius. The two centres will support the development and application of innovative ideas in technical areas relevant to CERN activities. The Lithuanian businesses will be able to participate in CERN's multi-million euro public procurement projects, while researchers will be able to contribute to major inventions, mainly to research particle physics. Lithuania became an associate member state of CERN in 2018.

The government is creating disincentives for the purchase of cars run on diesel. In August 2019, the government announced that it aims to reduce the country's reliance on old diesel-fuelled cars. The government envisages cash subsidies of €1,000 for citizens who choose to exchange their old diesel cars for newer ones running on petrol, gas or hybrid, which pollute the air less. Currently, about 75 per cent of all cars in Lithuania run on diesel.

Plans for a rail connection between the Baltic Sea and the Black Sea are advancing. In May 2019, the railway representatives of Belarus, Ukraine and Lithuania signed an agreement to launch a container train service between Klaipeda and Odessa. The cargo train connection aims to replace road transportation, is more environmentally friendly and may reduce transportation costs by an estimated 25 per cent.