DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR LITHUANIA

As approved by the Board of Directors at its meeting on 10 February 2016

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EXECUTIVE SUMMARY

The Republic of Lithuania is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with Article 1 of the Agreement establishing the Bank.

Lithuania has weathered the financial crisis well, and has since exhibited one of the highest growth rates in the EU, averaging approximately 4 per cent annually since 2011. Accession to the euro area in 2015 underlines how much the country has accomplished in terms of macroeconomic stabilisation, and will help Lithuania mitigate some financial sector risks. Stabilisation efforts have been underpinned by a range of structural reforms which have made the at present strong growth rates more sustainable.

The recent recovery has been primarily driven by domestic demand, with an improving labour market and continued real wage growth allowing private consumption to pick up materially in 2014. Growth in 2015 was weaker as the impact of Russia's recession was felt, although quantitative easing in the Eurozone and lower import prices will likely provide a boost. Investments in the past three years were underpinned by the strong absorption of EU funds. Lithuania has been allocated €8.4 billion under the new EU structural and investment funds (ESIF), which began disbursing in 2015.

At the same time, the very open economy is exposed to regional volatility, innovation performance has been weak and significant medium-term challenges remain. Exports of high-tech goods also remain relatively low, at only 5.6 per cent of total exports, well below the EU average. The key challenge for Lithuania is to develop a more innovation-led growth model, with a greater value-added component.

Costs of energy and security of supply also remain a concern. Lithuania relies heavily on imported energy from a single supplier and domestic generation of electricity produced by renewable sources is relatively low. While the new LNG terminal and two inter-connectors to Poland and Sweden, expected to be operational this year, are major improvements to the energy landscape, more is needed to strengthen energy supply security and efficiency.

In designing its support and related instruments, the Bank will tailor them to the advanced stage of transition of Lithuania. As Lithuania's transition has become more advanced, the Bank has accordingly narrowed the scope of its activities as a consequence of the fewer market segments in which Bank activities can satisfy its operating principles (transition impact, sound banking and additionality).

Lithuania reaffirms its commitment to the principle of graduation. Although there has been significant progress in its transition to a sustainable market economy, some gaps remain and new challenges have arisen related to uncertainties in the broader geopolitical and investment environment. Lithuania will continue to keep the question of graduation under review and will indicate its graduation intention at the appropriate time.

To help Lithuania address these challenges, the Bank will pursue the following focused strategic orientations in the new Strategy period:

- **Bolstering energy security and increasing energy efficiency.** Given Lithuania's heavy reliance on imported energy, the Bank will support the further integration of the

Lithuanian energy market with the rest of the EU, as well as investment in local energy production from renewable sources. The Bank will also seek to facilitate investments in energy efficiency.

- **Enhancing private sector competitiveness through innovation.** New investment in high-value added production and innovation is badly needed to enhance capacity, provide important demonstration effects to other businesses and achieve sustainable economic growth. The Bank will look for opportunities to invest, directly and indirectly (including through private equity funds) in support of innovative and potentially competitive companies.

1 OVERVIEW OF THE BANK'S ACTIVITIES

1.1 The Bank's current portfolio

Private sector portfolio ratio: 100 per cent, as of 31 December 2015

Sector Group	Sector Team	Portfolio no of operations	Portfolio (€m)	% Portfolio	Op Assets	% Op Assets
Energy	Natural Resources	0	0	0%	0	0%
	Power and Energy	0	0	0%	0	0%
		0	**0**	**0%**	**0**	**0%**
Financial Institutions	Depository Credit (banks)	3	38	43%	38	58%
	Insurance, Pension, Mutual Funds	0	0	0%	0	0%
	Leasing Finance	0	0	0%	0	0%
	Non-depository Credit (non-bank)	0	0	0%	0	0%
		3	**38**	**43%**	**38**	**58%**
Industry, Commerce & Agribusiness	Agribusiness	1	0	0%	0	0%
	Equity Funds	16	36	41%	14	21%
	ICT	3	8	9%	8	13%
	Manufacturing & Services	0	0	0%	0	0%
	Property and Tourism	0	0	0%	0	0%
		20	**45**	**51%**	**22**	**34%**
Infrastructure	Municipal & Env Inf	1	2	2%	2	3%
	Transport	1	4	4%	4	6%
		2	**6**	**6%**	**6**	**8%**
Summary		**25**	**88**	**100%**	**65**	**100%**

Source: EBRD Business Performance Navigator

1.2 Implementation of the previous strategic directions

Over the previous country strategy period, the Bank's main priorities in Lithuania have been to: (1) help enterprises expand and improve their competitiveness; (2) strengthen and consolidate local banks; (3) commit capital to regional equity and mezzanine funds targeting SMEs; (4) strengthen energy security and improve energy efficiency; and (5) encourage private sector participation in infrastructure.

In making investments against these strategic priorities, the Bank has been targeted in its approach, bearing in mind the need for high transition impact and additionality. Hence, over this period, the Bank signed only 9 new transactions, totalling just over €76 million. All bar three projects have been regional in focus, with 6 investments in private equity funds, two in the transport sector and one in information technology. Notably, the Bank has:

- Launched the Integrated Approach for the Further Development of the Venture Capital and Private Equity (VC/PE) Ecosystem in the Baltic States (the "Baltics IA") which aims to facilitate the emergence of a strong, more sustainable VC/PE sector in all three countries, with equity and quasi-equity/mezzanine financing available at all growth stages of companies. The Baltics IA is helping to address the key transition challenges of the Baltics VC/PE ecosystem through a two-pronged methodology that pairs investments into identified VC/PE funds across the financing lifecycle with targeted policy dialogue addressing barriers to further development.

- As part of the Baltics IA invested in three Baltics dedicated private equity funds, managed by local teams and focused on SMEs. One was a mezzanine fund, with the Bank's support further developing the market for this still rare instrument in Lithuania. The other, Baltcap II, follows a buy-and-build strategy, incorporating cross-border activity, which will help integrate investments across all three Baltic States. Baltcap II has made two investments totalling €9 million in a Lithuanian waste management company, Ecoservice, and now owns 100 per cent of it. And in June 2015 the Bank signed a €17 million investment in Livonia Partners Fund I. The Fund will have a generalist sector strategy and will provide growth and acquisition capital to companies in the Baltics. In addition, as part of its Venture Capital Investment Programme, in May 2015 the Bank signed a €2 million equity investment in Trafi, a leading mobile application and internet web service that allows urban dwellers to plan public transport journeys and receive real time schedule updates.
- In addition the Bank has maintained a close dialogue with relevant stakeholders, including three Baltic-wide capacity building events for existing and aspiring Baltic fund managers covering, among other topics, regulatory and legislative aspects affecting the VC/PE sector (e.g., local collective investment vehicles laws or procurement procedures) and other means of improving networks among the Baltic states and beyond in order to realise synergies among market participants.
- In close co-operation with the Lithuanian authorities, converted a senior convertible loan for Siauliu Bankas into a subordinated loan in order to support Siauliu's acquisition of certain liabilities and assets from a failed bank, Ukio Bankas, thereby significantly contributing to stabilising the banking market in Lithuania.
- Signed a loan of €32.5 million for Klaipedos Smelte to support development of a container terminal. The loan was later restructured and the amount lowered to €27.5 million due to implementation delays and the effects of Western sanctions on Russia and counter-sanctions on the EU. The company was recently recognised for the project's direct role in developing transparent and effective business practises, creating new jobs and increasing the competitiveness of the Klaipeda seaport.
- Continued policy dialogue with the authorities to develop Energy Performance Contracts (EPCs) in order to improve availability of financing for energy service companies making energy efficiency investments in various sectors of the economy. Some technical assistance has also been provided. The implementation of EPCs will help leverage the usage of EU funds as well as increase private sector involvement in energy efficiency related services and investments.
- The Bank administers the Ignalina International Decommissioning Support Fund (IIDSF). The Fund has financed two key Ignalina Nuclear Power Plant (INPP) decommissioning support facilities for interim storage of 17,000 RBMK spent nuclear fuel assemblies and for solid waste management and storage of 120,000 m^3 of solid radioactive waste, pre-commissioned in October 2014 and August 2015, respectively. The Fund also facilitated consultancy services in support of the development of the power interconnection between Lithuania and Poland.

1.3 Key lessons

During the financial crisis the Bank was constructively flexible in its response, as it concentrated on helping stabilise local financial markets. Even as Lithuania has emerged from the crisis, however, credit growth and foreign investment remain low. The Bank's ability to provide long-term financing, as well as equity, can thus enable investment at a time when the mostly foreign-owned banks are deleveraging.

The financial sector in Lithuania has offered few alternatives to traditional bank lending, and the Bank, working with stakeholders ranging from investors to other IFIs and regulators, will have an important role to play in increasing the availability of equity in the economy. A key element of this integrated approach will be the Bank's investments in regional PE/VC funds, including those noted above.

Energy security is also gaining in importance, particularly as geo-political uncertainty persists. The Bank can play a role in regional integration and support local energy generation, as well as facilitate financing structures that increase private sector involvement in providing much needed energy efficiency investments in public, commercial, industrial and residential buildings.

2 OPERATIONAL ENVIRONMENT

2.1 Political context

The current centre-left coalition government has been in power since general elections in October 2012. It is led by the Social Democratic Party and comprises the Labour Party and the Order and Justice Party. The coalition commands a comfortable majority in the parliament (even after the party representing ethnic Poles withdrew from the coalition in August 2014) and has proved more stable than initially anticipated. The government has continued many of the policies of the previous centre-right coalition, including securing Lithuania's accession to the Eurozone as of 1 January 2015. Popular trust in the main political parties remains limited, however, in particular in big cities, which was confirmed by results of the local elections on 1 March 2015.

Policy continuity has been secured not least thanks to the strong leadership by popular President Dalia Grybauskaitė who was elected to a second term in May 2014 against the background of rising geopolitical tensions in the region. The latter have had a significant impact on Lithuania, turning national defence and security into a key priority shared by the vast majority of the country's political forces. The next parliamentary elections are scheduled to be held in the autumn of 2016.

2.2 Macroeconomic context

As with the other two Baltic economies, Lithuania has steadily recovered from the peak of the 2009 recession. Having avoided the worst financial excesses, the collapse in local asset prices was milder, bank deleveraging less precipitous, and the economy in 2014 regained its pre-crisis income levels. That said, the very open economy is exposed to regional volatility, as a slump in growth partly from Russia's recession in 2015 demonstrated. Innovation performance has been weak, and medium term challenges such as aging and labour force shrinkage persist.

Following the correction in the large external deficit, Lithuania's recent recovery has been primarily driven by domestic demand. The improving labour market situation and continued real wage growth allowed private consumption to pick up materially in 2015. However the contribution of net exports turned negative, mostly due to the slowdown of the Russian economy, the significant depreciation of the Russian rouble and counter sanctions on agricultural produce of EU origin. Although banks continued to remain cautious in lending, enterprises and households were able to finance large shares of investments from their own resources, positively contributing to growth. In the past three years investment grew strongly in part due to the strong absorption of EU funds, particularly during 2013-2015.

Lithuania became the 19th Eurozone member in January 2015. It followed in the footsteps of its two Baltic neighbours, Estonia and Latvia, which adopted the euro in 2011 and 2014, respectively. Eurozone membership eliminates remaining currency risk premia in lending, and credit risks resulting from an independent currency regime. The domestic banking system remains predominantly owned by Scandinavian parent banks, although it has now gained access to the ECB's liquidity facilities and became subject to the ECB's single supervision.

Exports held up well in 2015, even as sanctions and economic contraction impacted Russian trade partners. This has been attributed to the successful re-orienting of trade to other markets. In 2015, exports of Lithuanian-origin goods to Russia declined in value by around 50 per cent compared to the same period previous year; still, the growth of total export volumes remained positive.

There is much anticipation of the new EU structural and investment funds (ESIF) which began disbursing in 2015 (an allocation of €8.4 billion). The government was among the very first in the EU to have its operational programmes approved. A Public Investment Development Agency ("VIPA") has been established to combine EU funds with private investment. This type of financial instrument is innovative and could attract private investors to Lithuania over the medium term, well beyond the present EU funding round, thereby securing sustainable public investment. Private investments are expected to recover further, though at a level of roughly 15 per cent of GDP in 2014 they still remain well below the pre-crisis peak of 23 per cent in 2007, and lag well behind the recovery seen in other countries in the region.

There have also been some improvements in the labour market, with unemployment falling to 8.5 per cent in December 2015, though its structural component remains high. Real wages continue to rise, supported by very low inflation and deflation since the end of 2014. Labour productivity has been growing rapidly in the post-crisis period and currently is the highest in the Baltic region, amounting to almost 75 per cent of the EU average. However, real unit labour costs have been rising at a pace well above productivity, thereby posing some risk to external competitiveness.

2.3 Structural reform context

Until recently, Lithuania's priority has been macroeconomic stabilisation, which culminated in the accession to the Eurozone in January 2015. However, stabilisation efforts have been underpinned by a range of structural reforms which have made the at present strong growth rates more sustainable. Foremost has been the strengthening of fiscal governance, including through the adoption of the EU's fiscal compact. Financial sector risks have also been mitigated – the two largest domestic banks were closed as poor governance was exposed. Finally, significant reforms were undertaken within state-owned enterprises whose assets account for 25 per cent of GDP. Financial disclosure has been strengthened, professional standards have been set for board directors, and non-commercial functions have been more clearly separated.

As in other transition countries in the Central Europe region, Lithuania has exhausted productivity gains from the reallocation of factors of production across sectors, and productivity growth needs to be reinvigorated through firm level innovation. This will need to be implemented through the adaptation of existing technologies that are new to the country, alongside local innovation that expands the technological frontier. Comparative data from the EU on a range of indicators, including the employment of a skilled labour force and share of technology-intensive exports, confirms that Lithuania remains among the poorest performers in the EU in this regard.

Going forward, the authorities recognize the need to support the move towards a more innovation-led growth model, with a greater value-added component. Public and private R&D total expenditures remain only 0.9 per cent of GDP, significantly below the Europe 2020 target of 1.9 per cent. Exports of high-tech goods also remain relatively low at only 5.6 per cent of total exports compared with the EU average of 15.4 per cent.

A key priority for the coming years will be labour market reforms to raise labour force participation, and adjust employment protection. The working age population is projected to decline by 44 per cent between 2013 and 2040, due to aging, as well as ongoing emigration. Lithuanian statutes still provide among the strictest employment protection in the EU, perhaps fuelling a high share of the shadow economy, which is estimated at about 28 per cent of GDP. The new labour code that is currently under discussion could make labour relations more balanced, and appeal to investors.

In addition, a major reform programme, the so-called “New Social Model”, is currently before the parliament. This legislation would update the social security system, including pensions, social benefits and other labour market regulation, primarily aimed at liberalising the relationship between employers and employees. Through this new model, the government hopes to stimulate job growth, in particular by attracting foreign experts, while also trying to recover outgoing talent from the country.

The education system produces a large number of university graduates, though skills seem poorly matched to the needs of industry. Enrolment in vocational education and training is low, and skills and qualifications produced seem poorly monitored and likewise not well suited to the needs of industry.

Costs of energy and security of supply remain a major concern. Lithuania has been paying the second-highest gas price in Europe, and together with Latvia and Estonia, is considered one of the EU’s energy islands. Inter-connectors to Poland (LitPol) and Sweden (NordBalt) will be established in 2016, and the new LNG terminal is a major change in the energy landscape, though more work on energy supply security and efficiency will be required.

Finally, the government continues to support the development of outsourcing services. Given that the services sector constitutes almost two-thirds of Lithuania’s GDP and attracts about one-half of inward foreign direct investment, the government seeks to establish the country as a leading service and outsourcing hub in northern Europe.

2.4 Access to finance

Private sources of capital
In 2014 Lithuania's sovereign credit ratings were upgraded to A- by two international rating agencies (Standard & Poor and Fitch), while Moody's has kept its Baa1 rating in place since April 2009. In the view of all three agencies, Lithuania's Eurozone accession in January 2015 increased the credibility of macroeconomic policy. Common standards of supervision and potential support within the banking union reduce financial system risk.

Lithuania successfully tapped international capital markets in 2014. It managed to issue a ten-year €500 million Eurobond in January 2014, followed by another borrowing of €1 billion at a record-low interest rate of 2.125 per cent and a record-long debt maturity of twelve years.

Bank deleveraging has significantly abated, with a minor net inflow for the year as of the third quarter of 2014, though this includes an outflow from Lithuania of about 3 per cent of GDP in the last six months. Credit outstanding to non-financial corporations has continued to contract in 2014, albeit at a reduced pace, with long term credit in excess of 5 years still unwinding rapidly. According to the November 2014 central bank survey of lending conditions, banks have eased lending standards, decreasing their risk margins and requesting less demanding collateral requirements. In terms of consumer financing, Savy, the first Lithuanian peer-to-peer lending platform for private individuals is active in Lithuania as an alternative to traditional bank financing. It remains to be seen if the development of alternative financing platforms is as successful in the Baltics as it is in other jurisdictions like the UK.

A sustainable venture capital and private equity sector is as yet not in place. While the banking sector is well developed this will limit the capacity of firms to invest in own technology and new plant and equipment.

The commercial bond market is still poorly developed in Lithuania. Corporate issuance is against the background of a relatively strong sovereign rating (A-/A3) and substantial sovereign bond issuance. However, the greatest difficulty that Lithuanian companies have in accessing capital markets is the size of individual companies and the size of the Lithuanian market, which is limited to those investors willing to expend the amount of resources necessary to conduct due diligence on both the country and the individual companies and to accept the limited liquidity that is associated with smaller issuers. On the corporate side three companies went for initial issuance, supported by renewed appetite from domestic pension funds (as of the end of 2014, Lithuanian pension funds (Pillar II and III) had reached €1.8 billion and €48 million, which is equal to 4.5 per cent and 0.1 per cent of GDP respectively). The local bond market platform that is operated by the local stock exchange (NASDAQ Vilnius, which is part of the Nasdaq Baltic Market, and is 96 per cent owned by NASDAQ) seeks to reduce regulatory friction in issuance and trading, though as yet remains illiquid and has failed to elicit foreign investor interest.

Foreign direct investments in Lithuania have dropped sharply, to 0.8 per cent of GDP last year, with the latest figure representing the lowest amount since the mid-crisis in 2009. Software and IT services accounted for the biggest portion of inward investment projects.

Multilateral and bilateral development bank finance

During the 2007-2013 planning period Lithuania was eligible for up to €6.8 billion in EU structural funds. Lithuania's absorption rate has been among the best, and stood at 86.5 per cent at the end of March 2015. For the subsequent planning period (2014-2020) €8.4 billion has been pre-allocated through the ESIF, €6.7 billion under Cohesion Policy, €1.6 billion under Common Agricultural Policy and €63 million from the Maritime and Fisheries Fund..

Lithuania will need to further establish 'Financial Instruments' (i.e., special purpose entities, typically under the ownership of the government and managed by international financial institutions), which will leverage EU structural funds with private investor funds. The entity created under government ownership for funding of municipal infrastructure and energy efficiency, VIPA, represents an important innovation in this regard.

In addition, as part of the comprehensive Jobs, Growth and Investment package ("Juncker Plan"), potential funding in the areas of transport, energy, knowledge and digital economy, social infrastructure and resources and the environment could be available from the European Fund for Strategic Investments (EFSI).

In addition, several other institutions have been active in the country, largely in the energy infrastructure and transport sectors:

- From early 2012 to the end of March 2015 the **European Investment Bank** (EIB) signed eleven loans totalling €347.5 million in Lithuania. Six operations worth €129.5 million consisted of credit lines for financial intermediaries to support lending to SMEs. Two loans were in the energy sector, an €87 million loan to support the LNG-terminal in Klaipeda and a €65 million loan to LitPol-link, the Polish-Lithuanian interconnector. Lithuanian Railways received a loan of €50 million for the purchase of rolling stock and a further two small loans were for a service and an industrial company. Lithuania and EIB have also signed an agreement to co-finance ESIF investments.
- Since 2011 the **European Investment Fund** (EIF) has committed €40 million to the Baltic Innovation Fund (BIF) (in 2012) with a partial allocation to Lithuania. Since establishment the BIF has extended funding to one private equity fund and one mezzanine fund, both pan-Baltic.
- The **Nordic Investment Bank** (NIB) has signed nine loans in Lithuania since end of 2011 totalling €377 million. Three loans were for Lithuanian Railways totalling €201 million, and a €44 million for Klaipeda State Seaport Authority and two for the City of Vilnius totalling €25 million, two loans were for the energy sector, a €50 million loan for Litgrid and a €35 million loan for Klaipedos Nafta.
- Since end of 2011 the **Council of Europe Development Bank** (CEB) has signed one operation in Lithuania in 2014, a loan of €100 million providing financing for the state investment programme in line with several CEB's sectors of action.

2.5 Business environment and legal context

Business environment

Lithuania's business environment remains conducive to starting and running an enterprise. The World Bank's 2016 *Doing Business* report ranks Lithuania 20th globally (out of 189 countries), one notch better than in the previous edition of the rankings. This score is significantly below Estonia, although considerably ahead of other countries in central Europe. Over the last year procedures for starting business were further eased, including as a result of accelerated procedures in accessing electricity. Enforcing contracts also became simpler as electronic filing systems for court users were introduced in 2014.

Nevertheless, there remain concerns over the efficiency of public institutions, in particular as regards procurement practices and the health sector. Provisions to combat corruption are strong, though may need to be applied more evenly. In addition, procedures for household insolvency still seem protracted, (even though banks' non-performing loans have been steadily reduced).

In the 2012-13 EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS), the top three business environment obstacles identified by Lithuanian enterprises were workforce skills, practices of competitors in the informal sector and electricity. Large and young enterprises put corruption in the 3rd place. Manufacturing enterprises considered access to finance to be the third most severe obstacle, while services enterprises put political instability in second place.

Legal context
Lithuania has an advanced system of commercial and financial laws and is often praised as one of the most effective EU member states in terms of implementing EU Directives. Such elements as efficiency of justice administration and widespread use of e-justice contribute to the positive perceptions of the court system. To ensure further improvement, significant efforts have been undertaken towards tackling corruption. In February 2015, the Council of Europe Anti-Corruption Group (GRECO) recognised that Lithuania had developed a "comprehensive normative and institutional framework to prevent and fight corruption".

Generally, the system for taking, perfecting and enforcing security over movable and immovable property in Lithuania is working well. The insolvency framework is generally in good order; however there is room for improvement in several areas. The principal recommended reform item is the introduction of a proper pre-insolvency restructuring framework that provides for a fast track pre-insolvency process and incentives to encouraging early filing. Consideration should also be given to enhancing the regulation of insolvency office holders, particularly in matters such as qualification and training, and the appointment system.

The public procurement legal framework is largely compliant with international best practices. As regards the framework for public-private partnerships (PPPs), the 2006 Law on Concessions, as amended, is a fairly modern piece of legislation and is supported by various guidelines and implementation rules.

Annex 4 offers more detailed analysis on the legal context for investments in Lithuania.

2.6 Social context

Although Lithuania has shown a significant improvement in standard of living since the beginning of transition, economic development remains affected by the relatively low purchasing power, with an average wage of €714.5 per month and minimum wage of €464 per month[1]. According to Eurostat, more than 30 per cent of the population was at risk of poverty and social exclusion in 2013, one of the highest shares in Central Europe and the

[1] Wages per month are expressed in PPS (purchasing power standards).

Baltics and significantly above the EU average. Since Lithuania joined the EU in 2004, it has improved its UN Human Development Index ranking, standing at 37th worldwide in 2014, just behind Slovakia and Poland. Lithuania lags behind its regional peers in terms of life expectancy with 73.3 years at birth, well below the EU average of 80.6 years. Income inequality also remains a serious social issue, evidenced by a Gini coefficient of 34.6, which is significantly above the EU average of 30.5.

Most notably, financial inclusion of Lithuanian youth and women lags behind the rest of Central Europe and the Baltics. Only 40 per cent of Lithuanian youth (below 25 years old) use financial services such as personal or business accounts and debit cards. Gender disparities still exist in some areas, with medium Inclusion Gaps for Gender[2], particularly in relation to equal opportunities in the work place. In the 2014 municipal elections, only 3 out of 60 mayors elected were women, down from 1 in 10 in 2012.

Lithuania's labour market experiences a significant skills mismatch, with an increasing lack of adequately skilled labour. Among others, the demand for highly skilled managers, engineers, doctors, and finance professionals is not being met, especially in areas outside major cities According to the World Bank's Enterprise Surveys, nearly 40 per cent of employers cited an inadequately educated workforce as a major constraint on their operations in 2013. Young workers are often over-qualified, and despite a steady decrease since the economic crisis, youth unemployment remained high at 19.3 per cent in 2014. In addition, an unattractive job market has led to emigration of the better educated. The resulting skills deficit is a particular concern for the private sector, and businesses have struggled to recruit skilled and motivated people, leading to operational challenges such as high recruitment and training costs and lower productivity.

As a result of high emigration and negative natural population growth, the country's population fell by 13.4 per cent (459,092) between 2003 and 2013. Of particular concern is that most emigrants are well-educated young people, resulting in a more rapidly aging population. The European Commission's 2015 Ageing Report suggests that over the next fifty years Lithuania's total population will decrease by 38 per cent, with a parallel drop in the total workforce of 34 per cent.

Public expenditure on education in Lithuania is at 5.17 per cent of GDP, which is among the highest in Central Europe and the Baltics. However, the quality of schooling lags behind the rest of Northern and Central Europe, with Lithuania one of three countries in the region with below OECD-average ratings in all categories. Although women's share of total enrolment in tertiary education is above 50 per cent and over four-fifths of female entrepreneurs have a post-secondary degree, gender segregation by fields of study is prevalent and appears to result into occupational segregation in the labour market.

Although a relatively small country, regional disparities exist in relation to sustainable drinking-water, sanitation services and central heating. Approximately 6 per cent of the population lacks access to improved sanitation facilities and 4 per cent to improved drinking-water, of which the majority is in rural areas (15 and 11 per cent, respectively). Regional disparities in part may be explained by the country's uneven economic development, which

[2] Medium gender inclusion gaps exist in 'Labour Practices, 'Employment and firm ownership', 'Access to finance' and 'Health Services'. Refer to Annex 3 (Economic Inclusion Gaps).

have left rural households less able to connect to the comparatively expensive centralised water infrastructure.

2.7 Energy efficiency and climate change context

Following accession to the EU in 2004, Lithuania began to rapidly liberalise its energy market. Lithuania's energy intensity, however, still remains nearly twice as high as the EU-28 average (0.44 CO_2/GDP versus 0.24 for EU). One of the main energy challenges for the country is that it remains heavily dependent on gas imports, mainly from Russia.

Energy-intensive industries account for one-half of total industrial energy consumption. Lithuania will need to address such challenges to move towards a more sustainable energy and resource efficient future, in order to achieve the long-term goals set by the EU for its Member States.

The country has set a final energy consumption savings target of 4.7 TWh between 2008 and 2016, 37 per cent of which is to be achieved in the household sector, 10 per cent in transport, 8 per cent in industry, 5 per cent in the commercial-public sector and 40 per cent through cross-sectoral measures (including building regulations, voluntary agreements with energy companies on energy efficiency measures (individual meters in households and industry), tax rebates and information campaigns).

Going forward, the challenge will be to promote investments in renewable energy and to improve energy efficiency and resource efficiency as well as to develop power interconnections in order to enhance energy security. Further efforts will be needed as well to encourage the development of energy service companies (ESCOs) with a focus on private and public buildings as great potential can be realised for these sectors.

According to the *National Energy Independence Strategy* (2012), by 2020 Lithuania aims to achieve a renewable energy level of no less than 23 per cent in its final energy consumption, including no less than 20 per cent in the electricity sector, no less than 60 per cent in the district heating sector and no less than 10 per cent in the transport sector. While Lithuania has already reached the 23 per cent target for the RES share in gross final energy consumption, it is only half-way to achieving its sectorial targets.

According to the national energy policy, Lithuania seeks to source at least 20 per cent of its final electricity consumption with power generation from renewable energy sources, largely biomass and wind. By 2020, Lithuania aims to install wind farms totalling 500 MW of power and increase the total installed power of biofuel plants connected to the power grid up to 355 MW. The regulatory framework for renewable energy has also introduced feed-in tariffs (e.g., €7.5 cents per kWh of wind power as of 4Q 2015) until 2020, with a cap on total capacity eligible for support. A climate policy is in place and geared to achieve EU 2020 targets.

3 STRATEGIC ORIENTATIONS

3.1 Strategic Directions

Lithuania has weathered the financial crisis well, and has since exhibited one of the highest growth rates in the EU. Accession to the euro area in 2015 underlines how much the country has accomplished in terms of macroeconomic stabilisation, and will help Lithuania mitigate some financial sector risks, as Lithuania has now gained access to the European Central Bank's (ECB's) liquidity facilities, and resolution fund.

At the same time, Lithuania is vulnerable to economic contraction in Russia, with whom it has close trade links, and will be affected by the geopolitical situation in its eastern neighbourhood. Political instability in the region could thus affect investor sentiment towards the country, and Lithuania's growth. The country also suffers from continual emigration, which depletes Lithuania's skilled labour force. Sustained high economic growth would expand local opportunities for the young, educated and skilled, and provide them with credible incentives to stay.

Lithuania stands to benefit from a substantial allocation of EU structural and investment funds over the coming seven years; however the allocation after 2020 will be markedly lower. This funding will increasingly shift away from the traditional grant-based instruments and towards commercially-based financial mechanisms that leverage private funds. Establishing the institutions and governance for attracting and sustaining private investor participation in publicly led projects will be a key to sustained growth.

The government has adopted a clear strategy to strengthen productivity growth, redress labour force shrinkage, and augment the skills base. However, as yet, productivity growth has been relatively weak, and Lithuania shows the fifth lowest innovation performance in the EU. Low-tech products account for the bulk of its exports.

To help Lithuania address these challenges, the Bank will focus on the following orientations in the new strategy period:

- **Bolstering energy security and increasing energy efficiency.** Lithuania relies to an excessive degree on imported energy and domestic generation of electricity produced by renewable sources is relatively low. The Bank will support the further integration of the Lithuanian energy market with the rest of the EU as well as investment in local energy production from renewable sources. The Bank will also seek to facilitate investments in energy efficiency.

- **Enhancing private sector competitiveness through innovation.** New investment in high-value added sectors and energy and resource efficient technologies is needed to enhance production capacity, and demonstrate to other businesses how upgraded capital and technologies will sustain growth. The Bank will seek opportunities to finance resource efficiency investments, and will support, directly and indirectly (including through private equity funds) measures to increase the availability of financing for growing companies.

In designing its support and related instruments, the Bank will tailor them to the advanced stage of transition of Lithuania. As Lithuania's transition has become more advanced, the

Bank has accordingly narrowed the scope of its activities as a consequence of the fewer market segments in which Bank activities can satisfy its operating principles (transition impact, sound banking and additionality). This is also intended to enable the Bank to gather further experience and develop its knowledge in its advanced markets that it could share in other parts of the EBRD region.

Likewise, during the strategy period, Lithuania's donor activities will continue to strengthen private sector development in the EBRD region and the authorities will seek opportunities to share their experience and expertise gained during Lithuania's transition with other countries in the EBRD region.

Reaffirming the principle of graduation and consistent with the Medium-Term Directions for the Bank (BDS14-098 (F)), the Bank considers that the main instrument for decision-making on graduation is the respective country strategies, jointly agreed by the Bank and country authorities. Lithuania reaffirms its commitment to the principle of graduation. Although there has been significant progress in its transition to a sustainable market economy, some gaps remain and new challenges have arisen related to uncertainties in the broader geopolitical and investment environment. Lithuania will continue to keep the question of graduation under review and will indicate its graduation intention at the appropriate time.

3.2 Key challenges and Bank activities

Theme 1: Bolstering energy security and increasing energy efficiency

<u>Transition challenges</u>

Despite improving energy connectivity between Lithuania and neighbouring countries, prompted by the EU's initiative to integrate regional energy markets, and developing storage capacity, energy security and competition in supply remain major concerns for Lithuania.

- Two electricity connections will be launched this year – one between Lithuania and Sweden (NordBalt) and one between Lithuania and Poland (LitPol) -- and interconnectors between Estonia and Finland are operating since 2014. As pan-Baltic transmission capacity increases, however, the Lithuanian distribution grid will need to be strengthened.
- Thanks to the new liquefied natural gas (LNG) terminal in Klaipeda, the Baltic States are able to import gas from sources other than Russia for the first time in their history. Two gas connections with Poland and Latvia are to be completed by the end of the decade. Estonia is seeking to build an LNG terminal in co-operation with Finland. And Latvia has sizable underground storage facilities (UGS). All of these combined emphasise the need for strengthening the pan-Baltic pipeline grid.
- Following the shut-down of the Ignalina nuclear power plant in December 2009, Lithuania went from being a net electricity exporter to having one of the highest import dependency rates among EU states. Ninety per cent of the country's electricity and two thirds of district heating produced domestically are fuelled by natural gas, underlining the potential ramifications in any disruption to supply.
- Apart from limited shale gas deposits, Lithuania has minimal natural gas reserves. No natural gas is produced domestically, and sustainable energy production is extremely limited.

- Lithuania belongs to the group of the least energy-efficient economies in the EU, with energy intensity twice as high as the EU-average. Despite recent acceleration of modernisation work in multi-apartment buildings, energy efficiency in buildings remains challenging. About 96 per cent of multifamily buildings were constructed before 1993, most of which suffer from outdated heating and insulation facilities. The transport sector also remains extremely energy intensive, due to low duties on motor fuels that are close to the minimum level set by the EU.

Operational response

- In order to support Lithuania's on-going integration into the regional energy market as part of strengthening energy links within the Baltics, as well as between the Baltic countries and their EU neighbours, the Bank will look to finance further development of the Lithuanian and Baltic energy infrastructure, mainly through projects focused on the efficient use and transfer of energy, electricity or gas, within Lithuania and the Baltics.
- To enhance Lithuania's energy security the Bank will seek to support local generation of electricity. Private sector participation in electricity generation is low. Private sector investments, mainly in renewable energy generation based on local energy sources such as biomass, waste, biogas and wind will be prioritised.
- Energy efficiency investments will be pursued mainly through a facility based on Energy Performance Contracts (EPCs). This will be done in co-operation with VIPA, a government agency under the Ministry of Finance. The facility will improve access to long-term funds for energy service companies that provide energy efficiency investments in buildings, as well as for municipal services such as street lighting.
- The EBRD, as Administrator of the IIDSF, will continue its cooperation with the Lithuanian authorities, INPP and the energy sector companies to ensure successful completion of all IIDSF-funded projects and, in particular, start the industrial operation of the Ignalina spent fuel and solid waste facilities in 2017 and 2018, respectively.

Policy dialogue and Technical Assistance

- The Bank's policy dialogue will focus on further improving the legal structure for EPCs. Some technical assistance is envisaged to help implement the EPC financing structure. The Bank will also explore the potential for any fee-based services, e.g., in fund management.
- Promoting the use of Financial Instruments, in conjunction with EU structural funds, to support the financial structuring of projects in the energy and resource efficiency sectors. VIPA represents an innovative approach which harnesses EU structural funds for commercially sound investment in bankable projects in energy efficiency and municipal infrastructure. Its success could have a valuable demonstration effect elsewhere in the region where such instruments are now being established.

Results Framework for Theme 1: Bolstering energy security and increasing energy efficiency

	CHALLENGES	OBJECTIVES	ACTIVITIES	TRACKING INDICATORS
1.1	Lithuania's economy has suffered from the relative isolation of its energy markets	**Strengthen regional energy market integration through cross-border energy connections and gas pipelines**	• Boost pan-Baltic transmission and storage capacity by financing interconnectors through, e.g., long term debt and equity for gas grid and electricity distribution companies, linked, where feasible, to the efficient use of the LNG terminal	▪ Evidence of increased regional interconnectivity of electricity and/or gas transmission, distribution or storage capacity as a result of Bank activities Transition Impact Monitoring System /Technical Co-orperation Results Framework (TIMS/TCRF) *(Baseline – established at projects' approval)*
1.2	Lithuania remains dependent on external energy suppliers; domestic generation requires additional private sector investment	**Boost Lithuania's energy security by increasing electricity generation from local, renewable resources and increasing private sector participation**	• Direct/indirect financing to generating companies ("gencos") using local energy sources, including renewables	▪ Number of investments in gencos utilising local energy sources, and evidence of improved financial and operational performance (TIMS/TCRF) *(Baseline – established at projects' approval)*
1.3	Lithuania's energy intensity remains one of the highest in the EU	**Improve energy efficiency**	• Finance energy efficiency investments, including through support for EPC framework to improve access to finance for ESCOs providing energy efficiency investments • Policy dialogue, including technical assistance, to facilitate development of regulatory structure for EPCs and co-financing from EU funds, in cooperation with VIPA	▪ Volume of energy savings achieved through Bank investments based on EBRD methodology in toe/year *(Baseline – 0)* ▪ Number of energy efficiency investments successfully implemented or financed *(Baseline – 0)* ▪ Evidence of successful strengthening of regulatory framework for EPCs *(Baseline – N/A)*
	Context indicator: Δ in Lithuania's energy intensity *(Source: Eurostat (Baseline (2013) – 266.6 kg oil equivalent/€1000))*			

Theme 2: Enhancing private sector competitiveness through innovation

Transition challenges

To sustain its presently high growth rates Lithuania will need to rapidly facilitate domestic and foreign inward investment, and adopt new technologies, including those transferred through FDI.

- Following the sharp drop in economic activity, Lithuania's post crisis recovery has been accomplished on the back of ample capacity reserves within enterprises. Despite strong growth in the past three years, gross fixed capital formation in 2014 remained almost 20 per cent below the pre-crisis peak. Labour productivity remains one quarter below the EU average.
- Investment in new technologies is particularly weak. Lithuania remains one of the lowest ranked countries in the EU according to widely followed innovation indicators such as the EU Innovation Scoreboard 2015.
- The transfer of technology from research institutions to the private sector remains inadequate, and research often fails to offer commercial applications. An initiative to foster better transfer through the so-called science valleys that would integrate higher education, research and commercial applications around science and technology parks has only had mixed success.
- The funding environment for innovative enterprises also needs to be improved. This finance will primarily need to be in the form of risk-oriented private equity and venture capital that appeal to institutional investors. Such forms of finance remain underdeveloped and fragmented between relatively small local markets.
- Lithuania will benefit from further allocations of EU structural and investment funds in 2014-2020 (€8.4 billion, or about 3.3 per cent of annual GDP). Beyond 2020 EU funding will likely be substantially reduced. Current funding will increasingly shift away from the traditional grants towards commercially-based Financial Instruments that provide equity, loans or guarantees to final beneficiaries. The government has already set up VIPA (which implements financial instruments for_the modernisation of multi-apartment accommodation, public infrastructure and energy efficiency) and "Investicijų ir verslo garantijos" (which implements financial instruments for SMEs) as innovative, government-owned financial agencies that will leverage EU funds in this way. However, their institutional underpinnings, including how sub-funds are managed, require further development.

Operational Response

- The Bank will continue its work under the Baltics IA and invest in regional PE and VC funds targeting the Baltics, thereby supporting the further development of local capital markets and improving the availability of various types of equity investments to expanding SMEs. The Bank will also seek ways to support the development of alternative financing mechanisms like crowd-funding and peer-to-peer financing.
- To facilitate the stability and competitiveness of funding and banking services provision for corporate, individual and in particular for SME sector, the Bank will continue to seek opportunities for supporting the diversification of the local banking sector and for strengthening the second tier and smaller banks.
- The Bank will seek to finance, through equity or debt, cross-border oriented companies and innovative producers of higher value added goods. In particular

cross-border investments by Lithuanian companies into other EBRD countries of operation where the Bank's local presence and involvement can facilitate investment will be supported. Resource efficiency and, in particular energy efficiency investments, by corporates will be targeted in order to improve their competitiveness.

- To bolster FDI into Lithuania, the Bank will support foreign companies' investments especially when these will include knowledge transfer, adoption of best business practices and/or improvement of corporate governance standards.
- The Bank will seek to deepen its engagement in Lithuania's knowledge economy by financing investments in innovation, research and development and adoption of modern technology in knowledge-intensive industries and by investment and aggregation (consolidation) in related Information Communication Technology (ICT) infrastructure.
- Mindful of proper risk-sharing between the public and private sectors, the Bank will work with the authorities to develop PPP structures, where appropriate, mainly to improve energy efficiency and transport infrastructure in a country, where transit-related businesses are an important part of the economy.

Policy dialogue and Technical Assistance

- The Bank will continue working under the Baltics IA together with market participants and authorities aiming to further improve the legal and regulatory environment enabling the PE/VC to grow in Lithuania. This will involve also some technical assistance for capacity building, early stage development support, creating and enhancing networks, and increasing the availability of information on VC/PE funds.
- The Bank will closely cooperate with the authorities through advisory to develop and structure PPP projects, coupled where possible with finance.

Results Framework for Theme 2: Enhancing private sector competitiveness

	CHALLENGES	OBJECTIVES	ACTIVITIES	TRACKING INDICATORS
2.1	Funding environment for innovative enterprises remains limited, and investment in new technologies is weak	**Strengthen private sector competitiveness through investment in innovative and export-oriented companies**	▪ Debt and equity investments in support of export-oriented and innovative producers of higher value-added goods, including, as applicable, those further developing adoption of modern technologies and/or Lithuania's knowledge economy	▪ Evidence of successful operation of export-oriented and innovative companies supported directly or indirectly by the Bank (qualitative account) *(Baseline – N/A)* ▪ Evidence of development of innovation or adoption of modern technology by local companies as a result of the Bank's investments (qualitative account) *(Baseline – N/A)*
2.2	Risk-oriented private equity and venture capital remain underdeveloped and fragmented	**Diversify sources of finance, including private equity and venture capital, as alternatives to the banking sector**	▪ Under the Baltics IA, investments in regional PE and VC funds targeting the Baltics, supported by policy dialogue and technical assistance to improve the legal and regulatory environment ▪ Support diversification of banking sector and second tier and smaller banks	▪ Evidence of availability of innovative financing (e.g., number of PE and VC funds financed) and number of innovative companies financed by client funds *(Baseline – 0)* ▪ Evidence of improvement in the regulatory environment as a result of the Bank's policy dialogue (qualitative account) *(Baseline – N/A)*
3.3	Increased private sector investment and participation are necessary to improve the operational management and financial sustainability of Lithuania's transport infrastructure services	**Increase use of private sector-led solutions to enable sustainable funding (potentially in conjunction with EU funds) and efficient management of transport infrastructure services**	▪ Encourage private sector participation and promote use of PPP structures in transport infrastructure via finance for concessionaires and policy dialogue ▪ Policy dialogue on development and structuring of PPP projects, potentially in conjunction with leveraging EU funds, in cooperation with VIPA	▪ Evidence of transport infrastructure services successfully outsourced to private sector (e.g., PPPs) (qualitative account) *(Baseline – N/A)* ▪ Evidence of improvements in PPP environment as a result of the Bank's policy dialogue *(Baseline – N/A)*
	Context indicator: Δ in Sub-indicator on Innovation systems from Adjusted Knowledge Economy Index *(Baseline (2013) – 6.67)*			

3.3 Potential Risks to Country Strategy implementation

The EBRD's ability to deliver on its strategy in Lithuania will be influenced by a number of factors outside the Bank's control. Where feasible, the Bank will work to address and mitigate these risks through proactive and sustained engagement with clients, the authorities and other stakeholders.

i. *Continued sluggish growth in Western Europe*

The rest of the EU is an important market for Lithuanian exports. As a result, any negative impact on the EU economy would be reflected in the local economy through a smaller contribution to gross domestic product from exports.

ii. *Continued geopolitical tensions surrounding Russia/Ukraine*

Lithuania's trade relations with Russia have been very close through Russia being an important export market and a source of energy for Lithuania. A changed geo-political situation arising from the Ukrainian conflict may trigger a deterioration of market confidence and economic outlook in major trading partners. Perceived increased risks might also deter foreign investors, although the EBRD's presence and support may mitigate this to some extent.

iii. *Low investment in the corporate sector*

For the Bank to be able to implement an important part of its strategy, the corporate sector in Lithuania needs to invest. The uncertain geo-political situation could lower investments in Lithuania and, more likely, cross-border by Lithuanian companies, thereby reducing the number of opportunities for the Bank. Belarus has been of growing interest for Lithuanian outward FDI, but also this activity could be affected by geo-political developments.

3.4 Environmental and Social Implications of Bank Proposed Activities

The relatively low density of heavy industry in Lithuania and the large areas of undeveloped land alleviate some of the more significant legacy issues neighbouring countries inherited from previous regimes. Notwithstanding, as in all countries, Lithuania faces a number of environmental and social challenges where development and good environmental and social governance exist together. The reported goal of the Lithuanian Environmental Ministry (LEM) is to ensure development exists alongside preservation of a healthy and clean natural environment, landscape and biological diversity, and make the optimal use of natural resources. Through support for projects in Lithuania and the application of the Bank's Environmental and Social Policy (2014) these challenges can be met and sustainable development achieved.

There is widespread awareness of environmental issues within Lithuania as a result of industrial accidents such as Chernobyl and large scale deforestation and habitat loss. Lithuania has made substantial progress in advancing the environmental and social agenda since joining the European Union and implementing EU Directives. There are further improvements to be made associated with the historic structure of the energy sector including heavy reliance on imported energy from Russia and underfunded municipal and public infrastructure, notably in terms of waste management, wastewater and public transport systems. The Bank has assisted and continues to assist in the financing of projects aimed at achieving compliance with EU standards.

Nevertheless significant challenges remain, notably in terms of restructuring the power sectors to achieve EU environmental standards and further energy independence. The recent implementation of the EU Industrial Emissions Directive (IED) is a challenge to many operators, notably as existing facilities must comply with Best Available Techniques (BAT) post-2016. In other sectors, Lithuania faces the need to move away from import energy economy and implement state of the art non-fossil fuel-based generation assets, such as renewable generation. The investments needed will require substantial capital and know how. The Bank will assist in this process to help Lithuania implement an energy independent, and continue assisting with the restructuring of the industrial sector. This aligns with the Bank's strategy to strengthen energy security and improve energy efficiency.

Challenges also exist in overcoming gender discrimination in employment related to recruitment practices, the lack of part-time work options on the labour market, a lack of flexible working arrangements, and declining numbers of women in management. The Bank will assist in this process by ensuring projects identify and overcome existing gender-bias in recruitment and employment practice, and thereby ensure that women are able to benefit equally with men.

3.5 EBRD co-operations with the European Union and Multilateral Development Banks (MDBs)

- The EBRD will continue to work closely and actively co-ordinate its efforts with the EIB, EIF, NIB, and EU to enhance the leverage of its investment financing by, where appropriate, jointly engaging in policy dialogue with the Lithuanian authorities, for example, in developing PPP projects.
- The Bank will also look for opportunities to co-finance projects with the EIB and/or the NIB, especially to increase private sector participation in infrastructure and energy.
- The Bank will also continue to co-operate with the EIB, EIF and NIB to support the development and use of new Financial Instruments to enhance the leverage of EU funds.

ANNEX 1 – POLITICAL ASSESSMENT

The Republic of Lithuania is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with Article 1 of the Agreement establishing the Bank.

The constitutional and legislative framework for a pluralistic parliamentary democracy is in place. The separation of powers and checks and balances in the political system, and guarantees for human rights and fundamental freedoms are largely in line with international and European standards. The media are pluralistic and competitive, and civil society is vibrant and diverse. Elections are conducted in a manner deemed by the Organization for Security and Co-operation in Europe (OSCE) and the Council of Europe to be free and in line with international standards. Since the restoration of independence in 1990, Lithuania has established a track record of multiple peaceful transfers of political power between parties and coalitions. The country became a member of the European Union in 2004 and joined the Eurozone as of 1 January 2015.

Lithuania has achieved further progress in democratic transition in the period since the last Strategy, although some challenges remain, in particular related to the rule of law.

Free Elections and Representative Government

The legal framework for elections is well suited for the conduct of democratic elections, according to the OSCE Office for Democratic Institutions and Human Rights (OSCE/ODIHR). The elections are competitive and voters are generally given a wide array of political alternatives, with a high number of contesting parties. The election administration is characterised by professionalism and impartiality, recognized by all contestants including the opposition, who are able to campaign freely in an environment respecting fundamental rights. Remaining OSCE/ODIHR recommendations relate to candidate rights, ethnic minorities and complaints and appeals in the current legal framework for elections.[3]

Lithuania is a parliamentary republic, with the legislative power lying with the 141-seat parliament, and executive power being divided between the government and the president. The political system is underpinned by the constitutional and legislative framework providing for a clear separation of powers and checks and balances of executive, legislative and judiciary. Lithuania's elected officials do not face undemocratic constraints on their powers to govern effectively.

Civil Society, Media and Participation

The legal framework enabling a diverse civil society to operate independently is in place. Civil society organisations (CSOs) have good access to political decision-making and the law-drafting process. Lithuanian citizens are free to form political parties by law, which is upheld in practice with the existence of well organised opposition parties that are able to campaign freely. The political party system has long been characterised by fragmentation, with frequent changes of government and fluid political party structures.

The Constitution guarantees freedom of expression and the right to information. Lithuanian media is pluralistic and expresses a wide array of political views. However, the ownership of media outlets has become more concentrated over the last few years and concerns were raised

[3] OSCE/ODIHR: Presidential Election 11 May 2014, Needs Assessment Mission Report, 11-13 February 2014, pp. 1-3, 11.

over big business trying to exert influence via media ownership. Defamation remains a criminal act, but the authorities have indicated their intention to decriminalise most defamation offences, which was welcomed by the OSCE Representative on Freedom of the Media.[4] Legal protection for investigative journalists exists and is generally observed in practice.

Rule of Law and Access to Justice

The Constitution guarantees all citizens equality before the law. The right to a fair trial for all is enshrined in the Constitution and freedom from arbitrary arrest and detention is guaranteed. The judiciary is independent and generally provides an effective check on executive and legislative powers. However, reported cases of corruption among judges have resulted in low public trust in the courts.[5]

Transparency International's 2015Corruption Perceptions Index ranks Lithuania 32nd out of 168 countries assessed (an improvement from rank 39 in 2014).[6] A comprehensive normative and institutional framework to prevent and fight corruption is in place and accompanied by overarching anti-corruption strategies. In order to address remaining issues, the Council of Europe's Group of States against Corruption (GRECO) recommended the Lithuanian authorities to focus on the implementation and enforcement of norms.[7]

Civil and Political Rights

Civil and political rights, including fundamental freedoms of speech, information, religion and conscience, movement, association and assembly are guaranteed by the Lithuanian Constitution and respected in practice.

Lithuania has a well-developed legal framework for the protection of minority rights. While the Polish and Russian ethnic communities are well integrated, concerns remain about the treatment of the Roma minority.[8]

Principles of equal opportunities and equal treatment for men and women are enshrined in the Constitution and covered by relevant four-year National Programmes. The UN Committee on the Elimination of Discrimination against Women (CEDAW) welcomed the progress achieved with the adoption of necessary legislation and Lithuania's efforts to improve its relevant institutions and policy, while offering a number of further recommendations.[9] Lithuania's gender pay gap has decreased from 22.6 per cent in 2007 to 12.5 per cent in 2013.[10] 23 per cent of members of parliament are female, as well as the President of the Republic and the Speaker of the Parliament.[11] The UN Economic and Social Council (ECOSOC) recommended Lithuania to take further measures to enhance rights of people facing discrimination on grounds of their sexual orientation or gender identity.[12]

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[4] OSCE Representative on Freedom of the Media (2014), under: http://www.osce.org/fom/111091

[5] GRECO (2015): Fourth Evaluation Round Corruption prevention in respect of members of parliament, judges and prosecutors, Report Lithuania, p.5.

[6] Transparency International (2015): Corruption Perceptions Index 2015, under: http://www.transparency.org/cpi2015/results

[7] GRECO (2015): Fourth Evaluation Round Corruption prevention in respect of members of parliament, judges and prosecutors, Report Lithuania, p.5.

[8] ECOSOC (2014): Concluding observations on the second periodic report of Lithuania, p.2.

[9] CEDAW (2014): Concluding observations on the fifth periodic report of Lithuania, p.3.

[10] Eurostat: Gender Pay Gap, under: http://ec.europa.eu/eurostat/c/portal/layout?p_l_id=6556680&p_v_l_s_g_id=0

[11] Interparliamentary Union: General Information about the Seimas – Lithuania, under: http://www.ipu.org/parline-e/reports/2189_A.htm; World Bank Gender Statistics

[12] ECOSOC (2014): Concluding observations on the second periodic report of Lithuania, p.3.

The Constitution of the Republic of Lithuania provides for citizens' freedom from harassment, intimidation and torture, and these freedoms are observed in practice.

ANNEX 2 – SELECTED ECONOMIC INDICATORS

	2010	2011	2012	2013	2014	2015 (proj.)	2016 (forec.)
Output and expenditure			*(Percentage change in real terms)*				
GDP	1.6	6.0	3.8	3.5	3.0	1.6	3.0
Private consumption	-3.4	4.6	3.6	4.3	4.1	na	na
Public consumption	-3.6	0.2	1.3	1.0	1.3	na	na
Gross fixed capital formation	1.4	19.4	-1.6	7.0	8.0	na	na
Exports of goods and services	18.9	14.9	12.2	9.6	3.0	na	na
Imports of goods and services	18.7	14.2	6.6	9.3	2.9	na	na
Industrial gross output, excl. construction	6.1	6.6	3.8	3.3	0.3	4.5	na
Labour Market[1]			*(Percentage change)*				
Gross average monthly earnings in economy (annual average)	-0.2	1.9	3.7	4.8	4.5	na	na
Real LCU wage growth	-1.4	-2.1	0.5	3.6	4.3	na	na
Unemployment rate (annual average)	17.8	15.4	13.4	11.8	10.7	9.1	na
Prices			*(Percentage change)*				
Consumer prices (annual average)	1.2	4.1	3.2	1.2	0.2	-0.7	na
Consumer prices (end-year)	3.6	3.5	2.9	0.4	-0.1	-0.3	na
Fiscal Indicators			*(In per cent of GDP)*				
General government balance	-6.9	-8.9	-3.1	-2.6	-0.7	-1.0	na
General government revenues	35.4	33.5	33.0	32.9	34.1	na	na
General government expenditure	42.3	42.5	36.1	35.6	34.8	na	na
General government debt	36.2	37.2	39.8	38.8	40.7	42.5	na
Monetary and financial sectors			*(Percentage change)*				
Eurozone broad money (M2, end-year)	2.1	2.0	4.4	2.4	3.5	5.3	na
Credit to the private sector (end-year)	-7.4	-6.4	-0.8	-2.3	-0.9	4.3	na
Non-performing loans ratio (end-year)	20.0	16.6	13.6	11.0	6.5	6.0	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
ECB deposit facility rate	0.25	0.25	0.00	0.00	-0.20	-0.30	na
ECB main refinancing operations rate	1.00	1.00	0.75	0.25	0.05	0.05	na
ECB marginal lending facility	1.75	1.75	1.50	0.75	0.30	0.30	na
External sector			*(in per cent of GDP)*				
Current account	-0.3	-3.8	-1.2	1.6	0.1	na	na
External balance	-5.9	-6.6	-3.3	-2.6	-4.2	na	na
Export of good and services	53.2	62.2	67.3	68.7	65.6	na	na
Import of good and services	59.1	68.8	70.6	71.3	69.7	na	na
Foreign direct investment, inward	2.3	3.5	1.4	1.5	0.8	na	na
Gross external debt stock	85.8	80.1	77.8	69.8	69.9	na	na
Memorandum items			*(Denominations as indicated)*				
Population (thousand)	3 052.6	3 003.6	2 971.9	2 943.5	2 921.1	2 888.6	na
GDP (in billions of Euro)	28.0	31.3	33.3	35.0	36.4	37.0	na
GDP per capita (in Euro)	9 181.6	10 408.4	11 216.6	11 877.9	12 476.3	12 818.6	na
Share of industry, incl. construction, in GDP (in per cent)	29.1	31.0	30.7	30.7	31.0	na	na
Share of agriculture in GDP (in per cent)	3.3	3.8	4.4	3.8	3.4	na	na
Inward FDI (in million of Euro)	653.4	1 094.6	454.3	531.2	299.8	na	na
External debt/exports of goods and services (in per cent)	128.7	100.5	91.7	82.3	72.8	na	na

[1] Figures do not include emigrant workers abroad.

ANNEX 3 – ASSESSMENT OF TRANSITION CHALLENGES

Market Str:	Market Inst:	Key challenges:
CORPORATES		
Agribusiness		
Small	Medium	▪ Increasing the competitiveness of the sector by further focusing on standards and improved efficiency in overall resource use.
Manufacturing and Services		
Negligible	Small	▪ Improving the efficiency of public administration and the quality of the judiciary, as corruption is still affecting the business environment; ▪ Dedicating more resources in human capital development to strengthen the country's research and development capacities
Real estate		
Small	Negligible	▪ Although the sector is already well developed, market penetration of innovative construction techniques and technologies, including energy efficiency, could be further increased.
ICT		
Small	Negligible	▪ Further increasing competition in the wireline segment.
ENERGY		
Natural Resources		
Medium	Negligible	▪ Facilitating the establishment of well-functioning wholesale and downstream gas markets by encouraging the entrance of new private players.
Sustainable Energy		
Medium	Small	▪ Enhancing project development especially in housing and SME sectors; ▪ Further capacity for implementation of carbon finance projects.
Power		
Medium	Small	▪ Increase in private sector participation in generation and retail energy supply; ▪ Increasing cross border energy trading and regional integration.
INFRASTRUCTURE		
Water and wastewater		
Medium	Small	▪ Expanded use of PPPs and private sector participation more generally; ▪ Consolidated regionalisation process.
Urban Transport		
Small	Small	▪ A more holistic planning and regulation of the urban transport sector in the larger cities; ▪ Improved contractual arrangements for private operators in the transport sector traffic management and regulation.
Roads		
Medium	Medium	▪ Full privatisation of road maintenance companies; ▪ Introduction of performance based contracts;

Market Str:	Market Inst:	Key challenges:
		▪ Development of PPP projects in line with international best practice.
Railways		
Medium	Small	▪ Private sector participation in freight and other related services (e.g. wagon and container leasing); ▪ Further liberalisation and enhanced competition in the market; ▪ Development of multi-modal transport networks and operations.
FINANCIAL INSTITUTIONS		
Banking		
Small	Small	▪ Developing and facilitating growth of new innovative products (e.g., products related to Carbon Finance and Energy Efficiency); ▪ Ensuring sufficiently strong corporate governance of the locally-owned banks.
Insurance and other financial services		
Small	Small	▪ Developing and facilitating growth of new innovative insurance products.
Micro, Small and Medium-sized enterprises		
Medium	Small	▪ Increasing access to specialised finance through private commercial sources and promoting venture capital investments in SMEs; ▪ Improving quality of public services for SMEs such as training for financial reporting and business plan.
Private equity		
Medium	Medium	▪ Broadening companies’ access to PE and VC financing through facilitating the launch of new institutional quality (Baltic-focused) PE and VC funds; ▪ Facilitating development of the VC-related ecosystem in the country (e.g., through facilitating improved effectiveness of business accelerators).
Capital Markets		
Medium	Small	▪ Facilitating increase in liquidity in local capital markets, including by developing local institutional and private investor base.

ECONOMIC INCLUSION[13] GAP RATINGS - LITHUANIA

ECONOMIC INCLUSION		
Inclusion gap dimension	**Inclusion gap**	**Key challenges**
Youth		
Financial Inclusion	Large	▪ Improving the availability of initiatives such as the Business Development Fund, supporting young people starting their own business (including consultations).
Opportunities for Youth	Medium	▪ Establish work based learning opportunities for youth (such as internships, apprenticeships, trainee programmes) by improving the collaboration between private sector employers and education providers to ensure adequate skills matching and progress routes for young people from education and training into employment. ▪ Develop initiatives aimed at increasing the quality of vocational education and training (VET), to ensure a competitive and qualified workforce. This could be envisioned through the engagement of the private sector in the setting of national skills standards to improve Lithuania's National Qualification Framework.
Labour Market Structure	Medium	▪ Supporting Lithuanian's Reform Programmes aimed to increase labour market participation and employment assistance, particularly to young people with low levels of skills (such as the Lithuanian National Reform Programme (NRP).
Quality of Education	Medium	▪ Supporting initiatives to improve national Programme for International Student Assessment (PISA) score outcomes and implementations of the life-long learning concept. ▪ Improving work base learning opportunities for disadvantaged youth.
Gender		

[13] The EBRD Economic Inclusion gaps rate the institutions, markets and education systems across all of EBRD's countries of operation in terms of their capacity to extend economic opportunity to individuals regardless of their gender, age or place of birth. These gaps measure *differences* in opportunities – between 15 to 24-year-olds and older workers, and between women and men – rather than opportunity *levels*. Gaps are reported in this Country Strategy where there exists an Inclusion Gap above Small. These gaps are consistent with the EBRD 2014 Inclusion Gap update.

Labour Practices	Medium	▪ Incentivise private sector clients to improve equal opportunities practices, including equal pay, access to child care and female leadership programmes.
Employment and firm ownership	Medium	▪ Improving client HR policies with regards to increasing female employment, training opportunities and progress routes into management opportunities.
Access to Finance	Medium	▪ Build the capacity of local Banks to develop credit lines aimed at female entrepreneurs, combining access to finance, training and business advisory services.
Health Services	Medium	▪ Supporting better access to and quality of health care for women (particularly to improve contraceptive prevalence) as part of initiatives that seek to improve HR policies. ▪ Improve access to quality drinking water and sustainable wastewater services causing waterborne diseases, with a specific focus on women where a robust link can be established between water improvements and women's health (e.g. economic opportunities).
Regions		
Access to Services	Large	▪ Support further improvements of Lithuania's water and wastewater infrastructure in underserved rural areas.
Institutions	Medium	▪ Support national reform developments and other initiatives (such as the national employment strategy 2014-2020) in the area of employment and labour market policy towards greater labour market flexibility and security, skills mobility and promotion of entrepreneurship.

ANNEX 4 – LEGAL TRANSITION

Introduction

This annex offers critical analysis on selected legal topics relevant to the Bank's investment strategy in Lithuania during the forthcoming period. It is based on the assessments of commercial laws conducted by EBRD Legal Transition Programme.[14] For ease of reference, the analysis is presented along the main strategic orientations defined in this country strategy.

1. Strengthen energy security and improve energy efficiency

Lithuania is highly (for up to three quarters of its needs) dependent on energy imports, large portion of which comes from a single source. This makes energy security and diversification of energy supply key priorities of the country's energy policy, as acknowledged in the National Energy Independence Strategy (2012). Strengthening interconnectedness with European electricity networks would be one of the key measures in this respect. A liquefied natural gas (LNG) terminal in Klaipeda that started operating in 2014 should enable the Baltic states to import gas from sources other than Russia. Two electricity interconnectors with Sweden and Poland were scheduled for commissioning in 2015, and two gas interconnectors with Poland and Latvia are scheduled to be commissioned in 2019 and 2020, respectively.

On the regulatory level, measures have been taken to implement the Third EU Energy Package, in particular the unbundling in the electricity and gas markets, as reflected in the Law on Electricity and the Law on Natural Gas. Unbundling of the gas market included the sale by Gazprom of its stakes in two Lithuanian gas companies to state-controlled entities, which might undermine the effect of the reform.

Renewable energy

The major sources of renewable energy (RES) in Lithuania are wind, hydro and biomass. Lithuania reached its 2020 target (23 per cent) for the (RES) share in gross final energy consumption in 2013 already. However, Lithuania is only half-way through achieving its sectorial targets.

RES support measures include feed-in tariffs, release from responsibility for balancing subsidies, priority access to grid and tax exemptions. Feed-in-tariff maximum rates are being set quarterly by the National Control Commission for Prices and Energy and are guaranteed for 12 years. RES producers with capacity exceeding 10 kWh obtain feed-in tariff contracts through tenders. Certain subsidies for the RES producers are available from the Lithuanian Environmental Investment Fund (LEIF) and the Fund for the Special Programme for Climate Change Mitigation. The grid operators must ensure priority transmission and distribution of electricity from RES as well as optimise or expand their grids as may be required for RES plant connection. RES for heating and cooling purposes are exempt from environmental pollution tax reliefs. Since 2012, state- and municipal-owned buildings that are either new or subject to major renovation have been required to meet the renewable energy requirements for buildings, and as of 31 December 2014, all new buildings and existing buildings subject

[14] See www.ebrd.com/law

to major renovation will have to meet the renewable energy requirements for buildings. These requirements can be met by using RES-generated energy for district heating and cooling.

Increase the use of RES is among the top priorities in the country's National Reform Programme (2014). The 2013 amendments to the Law on Energy from Renewable Energy Sources aimed to ensure the protection of public interest and avoid increasing electricity prices and balance the development of RES, in particular solar. Ensuring consistency with the RES target achieved and adoption of further measures to achieve the sector-specific target would be the key areas of priorities for the government. In furtherance thereof, the development of the National Renewable Energy Sources Development Programme is underway, along with the inter-institutional measures of the National Renewable Energy Sources Development Programme.

Lithuania ratified the Kyoto Protocol to the United Nations Framework Convention on Climate Change in 2003. It has undertaken significant efforts to reduce greenhouse gas (GHG) emissions between 1990 and 2012. However, further progress needs to be made in this respect in order not to miss the Europe 2020 GHG targets.

Energy efficiency

Lithuania remains one of the most energy intensive economies in the EU (its energy intensity being more than twice the EU average) and thus, one of the least energy-efficient. Although its energy intensity reduced significantly between 1995 and 2004, the period between 2005 and 2013 was market by steady rise in energy intensity, which caused the country to come off track to meet the national EE target. Buildings and industry sectors are the largest final energy consumers and therefore have the greatest potential for improvement.

The National Energy Strategy (2012) envisages annual average increase in electricity demand in branches of economy by 3.7 per cent for the period until 2025. The Third National Energy Efficiency Action Plan (NEEAP) was adopted in 2014. The key strategic goal in the EE sector is to consume 1.5 per cent less energy each year until 2020. The indicative national EE target for 2020 is established, in accordance with the EU *acquis*, at 740 KTOE.

Modernisation of multi-apartment buildings has been a government priority, given that 96 per cent of multi-apartment buildings were constructed before 1993, using poor EE standards. In February 2015, the Government established the Energy Efficiency Fund earmarking EUR 80M for renovation of public buildings and street lighting; its main activity would be providing guarantees and loans for relevant projects. EE in Lithuania is also supported by EU Structural and Investment Funds through programmes for renovating multi-apartment and public buildings. There is no primary law on energy efficiency and the EE sector is mainly regulated by secondary legislation. Technical regulations maintain energy performance standards for buildings. Certain regulations are in place to provide consumers with the reliable and adequate information on energy performance (labelling) of energy-consuming products (e.g., household appliances), as well as on eco-design that seeks to improve environment-friendliness of products throughout their lifestyle.

The law on energy efficiency is still in the drafting stage and is claimed to incorporate the requirements of Directive 2012/27/EU. Its adoption will require respective amendments to existing energy, electricity, natural gas and other laws, which are also being prepared. Furthermore, amendments to legal framework for public procurement and budget structure are discussed to better incorporate energy efficiency norms into national legislation.

2. Further enhancing private sector competitiveness

Access to finance - Pledges and mortgages

Access to finance is a crucial part of developing the private sector and making it competitive. The Lithuanian Civil Code, which came into effect in July 2000, regulates taking mortgages over immovable property (Sec. 4.170 – 4.197) and pledges over movable property and rights (Sec. 4.198- 4.228). Generally, the system for taking, perfecting and enforcing security over movable and immovable property in Lithuania is working well. Through a number of reforms in the late 90s and early 2000, the country has equipped itself with an efficient and user-friendly legal and institutional framework.

A mortgage can be created by contract between the creditor and the debtor or unilaterally by the owner of the immovable asset and has to be evidenced in a notarised mortgage bond (contents specified in the Civil Code). Subsequent mortgages over same property are allowed and the priority is achieved on registration.

A security interest can be created over vide range of tangible and intangible property as well. The object of security may be any present or future movable thing and property rights. A pool of assets ("property complex") composed of movable property the composition and form of which changes constantly may be charged by a contract, including the goods in stock, equipment, claims etc. In such event the object of pledge must be defined by indicating the group of assets, and separate objects constituting the property complex shall not be individualised. Lithuanian law also recognises concept of "company mortgage", i.e., the mortgage of a company as an immovable property. An inventory of assets of the company must be annexed to the company mortgage contract. Parties to the company mortgage contract must indicate the total value of the object of mortgage in the contract.

Non-possessory security interests (pledges) and a number of "quasi" security interests (sales with the right of redemption, leasing agreements, and sales with reservation of title), as well as mortgages must be registered with the Hypothec Register in order to be valid. The Hypothec Register is operated by the Central Hypothec Agency that has 15 local offices at district courts. The registrars are supervised by the Ministry of Justice. The system is centralised, fully computerised and easily accessible through the Internet. All interested persons can search the data electronically, including the particulars of a charge. Records on mortgages over land and buildings are immediately transferred to the Real Estate Register, which database is interconnected with the Hypothec Register.

Enforcement of pledges is done out of court in accordance to the existing agreement between the pledgor and the pledgee (direct sale, appropriation for value, public auction), or if the parties did not agree, the pledged assets are sold by the pledgee at a public auction. Enforcement of mortgages, in contrast, takes place via public auction led by bailiffs or by mandatory administration. In both cases, enforcement is reported to work efficiently unless the debtor challenges the procedure.

Access to finance - Factoring and Leasing

Chapter XXX Leasing (Financial Lease), articles 6.567-6.574 of the Civil Code regulate financial leasing contract. Under Article 6.572 the lessor's rights of ownership in the object of the leasing agreement which is not subject to registration shall be valid against third parties only if the leasing agreement has been registered under the procedure provided for by laws. In the case of the lessee's bankruptcy, the lessor's rights shall be valid against the lessee's creditors and the administrator only if the leasing agreement has been registered under the procedure provided for by laws.

The registration is crucial to grant protection against third parties only with respect to items that are not registered (i.e., with respect to which possession indicates ownership). However, the Civil Code does not specify a procedure for registration. Leasing is not a regulated financial industry in Lithuania and the services can be offered without any special license.

Similarly to the approach to financial leasing industry under the Lithuanian legal system factoring is not a regulated industry and no special license is required for the provision of the service. There is no special legislation on factoring as well apart from general "assignment of claim" provisions of the Chapter VI of the Civil Code which provides basis for assigning account receivables. As a result there is no definition of factoring services or types of factoring transactions which can help increase legal certainty of the factoring transactions and hence reduce involved costs and risks of re-characterisation of transactions.

Insolvency

Lithuania's current insolvency regime contains two sets of commercial insolvency legislation: the Enterprises Bankruptcy Act ("EBA") and the Enterprises Restructuring Act ("ERA"). The EBR and ERD apply to all enterprises registered in Lithuania with certain exceptions such as credit institutions, insurance companies, investment companies and pension funds. There are currently no personal insolvency laws for individuals, although a draft personal insolvency law has been drafted.

The insolvency framework is generally in good order, however there is room for improvement in several areas. A current issue of concern is the fact that the insolvency framework does not facilitate pre-insolvency restructuring. There is no expedited fast track pre-insolvency process. The only pre-insolvency relief results from bi-lateral negotiations with the principal creditor, normally a bank. Moreover, there are no incentives to encourage early filling of pre-insolvency procedures.

In addition, the EBRD assessment of the Insolvency Office Holder (IOH) profession (the "Assessment") completed in late 2014 identified a number of areas where improvements could be made. It concluded that the appointment system should be reviewed to consider the various alternative approaches with a view to ensuring an appointment system that properly reflects stakeholders', and in particular creditors' views. It also recommended the expansion of the existing code of conduct for IOHs to include professional standards/rules (in addition to the existing ethical guidelines), and that IOHs should be required to provide regular reports to the court and creditors to enhance the transparency and accountability of the insolvency proceedings.