LITHUANIA

Highlights

- **The Covid-19 crisis has brought a period of robust macroeconomic performance to a halt.** With strong GDP growth, current account surpluses and fiscal stability, Lithuania had made progress towards European Union (EU) convergence in the past few years, but the coronavirus crisis has reversed this positive trend in 2020, as containment measures strongly affected consumption, investment, trade and the fiscal account.
- **The policy response to the Covid-19 crisis has been comprehensive.** The government announced an economic stimulus package of 11 per cent of GDP, which together with an effective control of the epidemic, allowed the economy to start its economic recovery relatively quickly.
- **A plan facilitating large investment has been announced.** In July 2020 the government announced a comprehensive plan of amendments that will create a “green corridor” for large investments in regional development.

Key priorities for 2021

- **Addressing inequalities should continue, including through education and healthcare reform.** As levels of poverty and income inequality are still among the highest in the EU, the minimum wage, universal child benefits and pensions have been increased. There is a risk that the Covid-19 crisis will exacerbate existing inequalities, both at social and regional levels, which reinforces the case for comprehensive reforms of education and healthcare.
- **Increasing tax collection is critical for a balanced fiscal stance.** As social spending is expected to increase, fiscal revenues will have to increase likewise. Improved tax collection is seen as one of the main solutions, as the shadow economy is still considerable in size, while the value-added tax gap is one of the highest in the EU.
- **An enhanced focus on innovation could stimulate the economic recovery.** The announced investment plan up to 2022, which focuses on innovation, human capital, energy transformation and infrastructure, is an important step forward, but its success will rely on effective implementation.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	2.5	4.3	3.9	4.3	-2.0
Inflation (average)	0.7	3.7	2.5	2.2	1.3
Government balance/GDP	0.2	0.5	0.6	0.3	-6.7
Current account balance/GDP	-1.1	0.5	0.3	4.2	7.2
Net FDI/GDP [neg. sign = inflows]	-0.9	-2.0	-0.8	-1.5	-0.5
External debt/GDP	86.2	82.6	78.1	67.7	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	42.7	41.0	40.5	39.5	n.a.

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Covid-19: macroeconomic implications

The economy is in recession but has shown resilience. Services such as retail trade, transport, accommodation and catering account for a relatively large share of economic output (32 per cent of GDP) and have been the most affected branches of the economy during the Covid-19 crisis. Disruptions in global value chains have affected manufacturing, reflected by the decrease in industrial production, which, nonetheless, almost recovered to 2019 levels by July 2020. Private consumption has also been hit, but the effect was short-lived, as in June 2020, retail sales have increased relative to 2019. The impact on exports has also been relatively shallow, thanks to the high share of food products in its exports structure. Investment activity has been most affected, declining by 20 per cent year-on-year in the second quarter, and remains a drag on recovery as credit growth has been negative in the summer months. As such, GDP growth dropped by only 1 per cent year-on-year in the first half of 2020.

Wage growth is expected to slow amid rising unemployment. Boosted by public sector and minimum wage increases, wage growth remained high in the first quarter of 2020 at 9.4 per cent year-on-year after rising by 8.8 per cent in 2019. However, Lithuania's first-quarter unemployment rate rose to 7.1 per cent, up by 0.6 percentage points compared with 2019, and further increased to 8.5 per cent in the second quarter.

A significant fiscal deficit has emerged. After the government recorded a surplus of 0.3 per cent of GDP in 2019, the situation has changed in 2020 as a result of a significant fiscal stimulus package and lower economic activity and revenues. Government revenues were 8.8 per cent lower than planned in January to April 2020, and the International Monetary Fund (IMF) forecasts the fiscal deficit for 2020 at -6.7 per cent of GDP in 2020 and -3.8 per cent in 2021. The IMF also forecasts that public debt will reach 48.3 per cent of GDP by the end of 2020.

The short-term outlook is positive but significant uncertainty remains. Currently, the EBRD forecasts GDP to fall by 2.0 per cent in 2020, given the resilience shown in the first half of the year but remaining uncertainty about the evolution of the pandemic. In 2021, a rebound by 4.0 per cent in 2021 is expected, driven by already-announced significant investments in infrastructure and innovation. However, these forecasts are contingent on no further major outbreaks of the pandemic that could halt the path of recovery.

Policy response to Covid-19

A major economic stimulus package was adopted. The package amounts to about 11 per cent of GDP and is focused on firm liquidity and employment support. In the first stage, a fiscal package of €2.5 billion (5 per cent of GDP) was announced in March 2020. Key measures include additional funds to the healthcare system, income support for the self-employed, wage subsidies for employees in affected firms, and expansion of state guarantee schemes. Support was extended by €1 billion in May with a focus on economic recovery, and includes wage subsidies for returning from unemployment, and increased unemployment benefits and social benefits. Monetary policy was also relaxed, as the Bank of Lithuania lowered the counter-cyclical capital buffer from 1 to 0 per cent and offered loans to liquidity-strained financial institutions.

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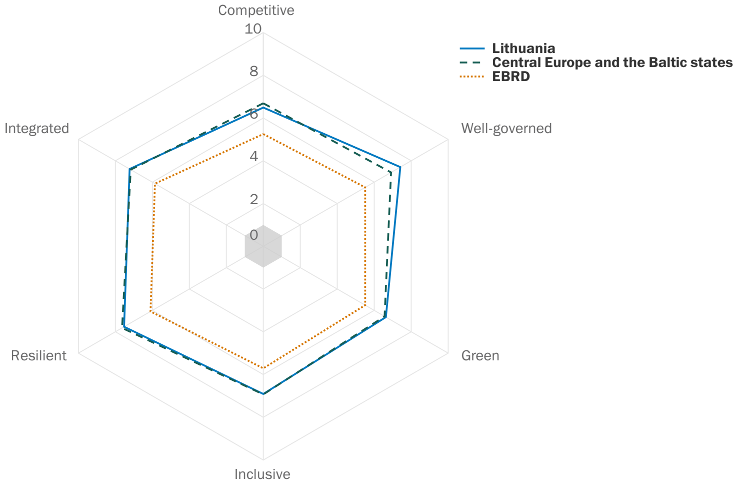
Assessment of transition qualities (1-10)



Structural reform developments

A new investment plan has been announced. In June 2020, the government published its public investment plan, called "The DNA of the Future Economy" worth €6.3 billion (13 per cent of 2019 GDP) to be invested between July 2020 and January 2022. Of the total amount, €2.2 billion will be new investments and the remainder is already-planned investment that will be accelerated, including by absorbing EU funds. The plan covers investments in human capital, the digital economy and business, innovation and research, infrastructure and climate change and energy.

Reforms to the business environment are advancing. The investment climate is being enhanced by a package of amendments to attract large investments through faster procedures in construction, land use, migration, as well as tax incentives, which will enter into force in January 2021. The goal of the "green corridor" is to attract investments in the post-Covid-19 possible reconfiguration of global value chains.

A new insolvency framework has entered into force. The new law came into force in January 2020 and aims to increase the efficiency of insolvency proceedings of legal persons, create conditions for the timely initiation of bankruptcy proceedings and greater satisfaction of creditors' claims, and promote the restructuring and preservation of viable legal persons in financial difficulty. The law states that insolvency occurs when liabilities are equal to assets or when a firm fails to meet its obligations, instead of overdue liabilities exceeding half of assets in the previous version. Thus, there is a risk that the new concept will create bankruptcy proceedings for firms in temporary financial difficulty, increasing the number of insolvencies.

The authorities have initiated plans to establish a National Development Bank and an Innovation Promotion Fund. The parliament has recognised the establishment of a state development bank as a project of national importance. The government has requested the EC's technical assistance in establishing this institution. Separately, a law initiated by the government will enable the Innovation Promotion Fund to be established in 2021. The idea is to facilitate innovative ideas for the financing of businesses.

The tax regime has been adjusted to cover additional social spending. To increase tax revenues, the Law on the Vehicle Registration Tax was adopted in December 2019, which introduces passenger vehicle taxation based on CO_2 emissions from July 2020. Second, the real estate tax brackets were adjusted downwards to cover up to 75 per cent of properties in Vilnius. Lastly, as of January 2020, the progressive personal income tax rate was reintroduced, increasing the rate from 27 per cent to 32 per cent for high earners.

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Progress in the energy sector has been notable. In May 2020 the parliament approved the liberalisation of the retail electricity market, which brings competition to the sector in a staged way depending on households' consumption levels. Energy security is also improving, as Lithuania has already reached interconnection targets for electricity and is now developing a new electricity interconnector with Poland. The development of a natural gas interconnector pipeline is also advancing, boosted by a state guarantee in Klapeida LNG terminal. Moreover, there has been progress in identifying the location of a new 700 MW offshore wind farm.