



REPUBLIC OF LITHUANIA

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

May 2015

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with the Republic of Lithuania, the following documents have been released and are included in this package:

- A **Press Release**
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on March 31, 2015, with the officials of the Republic of Lithuania on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 11, 2015.
- An **Informational Annex** prepared by the IMF staff.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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

On May 28, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with the Republic of Lithuania, and considered and endorsed the staff appraisal without a meeting.²

Growth has remained resilient, despite challenges in the external environment. Strong domestic demand growth on the back of improving labor market conditions underpinned real GDP growth of 2.9 percent in 2014. Exports held up reasonably well despite Russian import bans and the incipient recession in the CIS, reflecting a successful diversification drive into new markets and generally strong competitiveness. External factors were responsible for annual inflation of just 0.2 percent, with 12-month inflation rates dipping into negative territory toward year end.

Growth should remain largely unchanged at 2.8 percent from last year in 2015, as positive external factors counterbalance negative ones and domestic demand remains robust. The economic recovery in the euro area and low energy prices are major boons, but the deepening recession in the CIS and geopolitical uncertainty will hold back growth of exports and investment. Risks are moderately tilted to the downside, with deepening geopolitical tensions the main concern, although the effect of lower energy prices could surprise on the upside. Inflation will turn positive again, but average below zero for the year as a whole.

The main policy challenge will be to secure reasonably rapid convergence with living standards in Western Europe going forward. With macroeconomic stability and strong policy frameworks in place, the onus is mainly on structural reforms: fiscal structural reforms to lift spending efficiency and shift the tax burden away from labor; investment and innovation promotion

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

² The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

through use of EU funds and better focused policies; and making the most of demographically shrinking labor resources through education reform and a modernization of the labor code.

Executive Board Assessment

In concluding the 2015 Article IV consultation with the Republic of Lithuania, Executive Directors endorsed staff's appraisal, as follows:

Strong economic fundamentals and recent resilience to adverse external factors bode well for the near-term economic outlook. Legacies from the 2008/09 crisis have been largely worked off, with external and internal balance in place, strong public finances, private-sector balance sheets generally healthy, and policy frameworks strengthened in the context of euro adoption. Good economic performance despite adverse events in the CIS once again underscores the resilience and flexibility of the Lithuanian economy. Risks have moderated but remain tilted to the downside and relate mostly to external factors.

Over the medium term, convergence with living standards in Western Europe will depend critically on advancing the structural reform agenda. Investment needs to increase back to historical norms, labor resources should to be better utilized to mitigate the drag from worsening demographics, and more innovation is required in support of moving up the value chain and remaining competitive as wages converge toward EU levels. Contingent on such reforms, growth could rise to 3¾ percent over time.

Fiscal consolidation is almost complete but past gains need to be preserved to build more fiscal space over time. Public finances overperformed last year, but it will take measures of 0.4 percent of GDP to keep the fiscal deficit from deteriorating this year. The implied neutral stance is the minimum required under the SGP and broadly appropriate for Lithuania, considering the still slightly negative output gap. Moderate further consolidation of 0.3 percent of GDP next year would deliver the staff-recommended target for the fiscal structural balance of -0.5 percent of GDP, ensuring a steady but gradual decline of the public debt ratio over time, thereby regaining fiscal space needed to be prepared for future adverse shocks.

Fiscal structural reforms could usefully defuse future spending pressures, raise spending quality, and improve tax efficiency. Wealth taxes and tax administration should be strengthened to create room for lightening the labor tax burden, spending programs with subpar results should be reformed, and areas subject to likely future spending pressures should proactively be tackled. Formulating a coherent fiscal structural reform strategy could catalyze progress.

The stability of the largely Nordic-owned banking system has further strengthened, with increased capitalization, lower NPLs, high liquidity, and adequate profitability. Access to ECB liquidity and SSM participation are newly gained additional safeguards. But supervisors need to persevere with efforts to strengthen some smaller domestic banks and credit unions with higher

risk profiles and lower capitalization. Plans to fundamentally reform the credit union sector are welcome.

More private sector investment and innovation are needed to securely underpin continued income convergence. The lack of rebound in private investment after the 2008/09 crisis, still sluggish credit developments, and relatively poor innovation performance need to be addressed. Efforts to utilize EU funds and resources under the “Juncker Plan” are welcome, especially to the extent that they benefit SMEs, which have a hard time securing financing from risk averse banks. The effectiveness of innovation policies would benefit from reducing fragmentation in the current setup. An improved outlook for the availability of qualified labor would spur investment and innovation indirectly.

Making the best possible use of available labor resources in the face of adverse demographics is of paramount importance. Proposals for reforming the labor code are an opportunity to modernize labor relations and improve labor utilization. Education reform is of the essence to equip the labor force with a skill mix that better matches companies’ needs.

Republic of Lithuania: Selected Economic Indicators, 2012–20

	2012	2013	2014	2015	2016	2017	2018	2019	2020
	Projections								
Quota (current, % of total): 183.9 million SDR, 0.08 percent				Per capita GDP (PPP, 2014):			€ 20,088		
Main products and exports: mineral, chemical, agricultural and wood products, machinery and equipment, textiles				Literacy rate (2011):			99.7 %		
Key export markets: Russia, Latvia, Estonia, Poland, Germany				At-risk-of-poverty (after transfers), share of population (2013): 20.6%					
Output									
Real GDP growth (annual percentage change)	3.8	3.3	2.9	2.8	3.2	3.4	3.6	3.7	3.7
Domestic demand growth (year-on-year, in percent)	0.1	3.0	4.6	3.8	4.3	4.3	4.4	4.4	4.5
Private consumption growth (year-on-year, in percent)	3.6	4.2	5.6	3.7	4.2	4.0	4.0	3.9	4.0
Domestic fixed investment growth (year-on-year, in percent)	-1.6	7.0	8.0	3.2	5.4	5.5	5.5	6.0	6.1
Inventories (contribution to growth)	-2.1	-1.3	-0.8	0.0	0.0	0.0	0.0	0.0	0.0
Net external demand (contribution to growth)	3.9	0.5	-1.5	-1.0	-1.1	-1.0	-0.9	-0.9	-0.9
Nominal GDP (in billions of euro)	33.3	35.0	36.3	37.7	39.8	42.2	44.8	47.6	50.6
Output gap (percent of potential GDP)	-0.9	-0.3	-0.2	-0.2	-0.1	0.0	0.0	0.0	0.0
Employment									
Unemployment rate (year average, in percent of labor force)	13.4	11.8	10.7	10.6	10.5	10.5	10.5	10.5	10.5
Average monthly gross earnings (annual percentage change)	2.6	5.0	4.5	4.0	3.7	5.6	6.2	6.1	6.2
Average monthly gross earnings, real (CPI-deflated, annual percentage change)	-0.5	3.8	4.3	4.3	1.6	3.4	3.7	3.7	3.9
Labor productivity (annual percentage change)	2.0	1.9	0.9	2.6	3.2	3.4	3.7	3.7	3.9
Prices									
HICP, end of period (year-on-year percentage change)	2.9	0.5	-0.1	0.5	2.0	2.3	2.4	2.3	2.2
GDP deflator (year-on-year percentage change)	2.7	1.6	0.9	0.9	2.5	2.4	2.5	2.5	2.5
HICP core, period average (annual percentage change)	2.0	1.4	0.7	1.3	1.7	2.4	3.0	3.0	3.0
HICP, period average (annual percentage change)	3.2	1.2	0.2	-0.3	2.0	2.2	2.4	2.3	2.3
General government finances 2/									
Revenue (percent of GDP)	33.0	32.8	34.3	33.4	33.0	33.0	33.2	33.3	33.3
<i>Of which EU grants</i>	2.7	2.5	2.8	2.6	2.2	2.1	2.1	2.1	2.1
Expenditure (percent of GDP)	36.1	35.4	34.9	34.8	34.6	34.6	34.7	34.6	34.6
<i>Of which: Non-interest</i>	34.1	33.7	33.4	33.2	33.0	33.0	33.0	33.0	33.0
Interest	1.8	1.7	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Fiscal balance (percent of GDP) 3/	-3.1	-2.6	-0.7	-1.4	-1.6	-1.6	-1.5	-1.4	-1.3
Fiscal balance excl. Deposit Insurance Fund (percent of GDP)	-3.3	-2.2	-2.0	-1.6	-1.6	-1.6	-1.5	-1.4	-1.3
Structural fiscal balance (percent of potential GDP) 4/	-2.5	-1.7	-0.8	-1.2	-1.3	-1.3	-1.3	-1.3	-1.3
General government gross debt (percent of GDP)	39.8	38.8	40.9	38.9	39.0	38.7	38.2	37.6	36.7
<i>Of which: Foreign currency-denominated</i>	31.3	27.1	16.2	13.5	12.7	10.3	9.6	8.9	4.9
Money and credit									
Broad money (end of period, percent change)	7.2	4.4	1.2	..	..	..	..	..	..
Private sector credit (end of period, percent change)	0.3	-3.0	-1.1	1.5	2.0	..	..	..	..
3-month VILIBOR (period average, percent)	1.1	0.5	0.3	..	..	..	..	..	..
Reserve money (end of period, percent change)	-6.4	4.9	20.9	..	..	..	..	..	..
Balance of payments (in percent of GDP, unless otherwise specified)									
Current account balance	-1.2	1.6	0.1	0.5	-0.5	-1.1	-1.4	-1.7	-2.1
Exports of goods and services (volume change, in percent)	12.2	9.4	3.4	1.9	3.4	3.7	3.6	3.4	3.2
Imports of goods and services (volume change, in percent)	6.6	9.0	5.4	3.1	4.8	4.9	4.6	4.4	4.2
Foreign direct investment, net	-0.7	-0.6	-0.5	-0.4	-0.5	-0.7	-0.9	-1.3	-1.3
Gross official reserves (in billions of euros)	6.4	5.9	7.1	..	..	..	..	..	..

Reserve cover (in months of imports of goods and services)	2.9	2.4	2.9	..	..	..	..	..	..
Reserve cover (in percent of short-term debt)	50.4	52.1	57.8	..	..	..	..	..	..
Short-term debt at original maturity	25.3	23.4	21.5	20.0	18.2	16.4	14.7	13.1	11.6
Gross external debt 5/	73.4	67.1	66.7	57.8	53.3	49.0	44.6	40.3	36.1
Exchange rates									
Real effective exchange rate (2005=100, +=appreciation) 5/	117.5	118.7	119.9	..	..	..	..	..	..
Exchange rate (litai per U.S. dollar, end of period)	2.61	2.51	2.84	..	..	..	..	..	..
Exchange rate (litai per U.S. dollar, period average)	2.69	2.60	2.60	..	..	..	..	..	..
Exchange rate (litai per euro, end of period)	3.45	3.45	3.45	..	..	..	..	..	..
Saving-investment balance (in percent of GDP)									
Gross national saving	18.0	20.7	18.8	19.3	19.0	19.1	19.6	20.2	20.7
Gross national investment	19.2	19.1	18.7	18.8	19.5	20.2	21.0	21.9	22.8
Foreign net savings	1.2	-1.6	-0.1	-0.5	0.5	1.1	1.4	1.7	2.1

Sources: Lithuanian authorities; World Bank; Eurostat; and IMF staff estimates and projections.

1/ Data are presented on ESA2010, and BPM6 manuals basis.

2/ The projections for 2014 include 302 million euros (0.8 percent of GDP) in compensation payments for past pension cuts on accrued basis. The payments are spread over 2014-16, affecting the debt profile for these years. ESM contributions are spread over 2015-19 and also increase debt. Passive projections from 2016 onward; incorporate only announced budgetary measures; budgetary impact of further defense spending, wage compensation and their potential offsetting measures are not included.

3/ Fiscal balance for 2012 according to the definition for purposes of the Excessive Deficit Procedure (EDP).

4/ Calculation takes into account standard cyclical adjustments as well as absorption gap.

5/ Government external debt includes guaranteed loans.



REPUBLIC OF LITHUANIA

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

May 11, 2015

KEY ISSUES

Context and outlook. Lithuania's economic comeback over the past five years has been impressive. Real GDP has surpassed its previous peak and external and internal imbalances have been corrected. Euro adoption in January went smoothly and came with important upgrades to policy frameworks. Financial stability has increased further. Resilient growth in the face of recent external challenges speaks to Lithuania's strong economic fundamentals and augurs well for the future, but risks in the external environment persist.

Key policy issues. The Article IV discussions focused on policies to support the next chapter of convergence with living standards in Western Europe and to ensure continued stability in the face of population ageing and wage convergence with the EU.

- **Fiscal policy.** Repair of public finances has come a long way, but there is a need for some further consolidation to build fiscal space. Structural reforms to defuse spending pressures, raise spending quality, and reduce the tax burden on labor are also called for. The authorities should take corrective measure this year to avoid backsliding, target a structural fiscal balance of -0.5 percent of GDP from 2016 onward to put the public debt ratio on a downward trajectory, and articulate a strategy for fiscal structural reform.
- **Investment and innovation.** Both need to be stepped up. Plans to frontload and better leverage EU structural funds and tap resources under the "Juncker Plan" are welcome, especially to the extent they benefit SMEs. Fragmentation in innovation policies should be addressed. Investment will also depend on structural reforms, in particular measures that unlock labor resources and attract foreign investors.
- **Labor resources and structural reform.** With one of the most challenging demographic profiles in Europe, Lithuania needs to make the most of available labor resources. The labor market is rather flexible in practice, but the rigid and poorly applied labor code should be modernized, mismatches between skills taught by the education system and those sought by the labor market need to be addressed, and budget-neutral alternatives to currently high labor taxation should be actively considered.

Approved By
**Philip Gerson and
 Mark Flanagan**

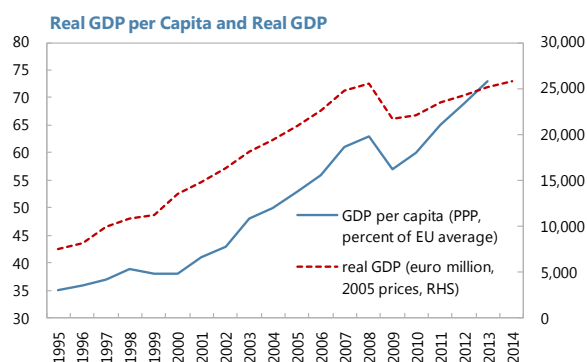
Discussions were held in Vilnius during March 19 - April 1, 2015. The team comprised Mr. Klingen (head) and Mses. Everaert, Geng, and Chen (all EUR). Ms. Arust (OED) joined the mission. Partners from the EC attended some meetings as observers. A conference call with SSM supervisory authorities was conducted in Vilnius, jointly with Bank of Lithuania representatives. Ms. Nguyen provided excellent research assistance.

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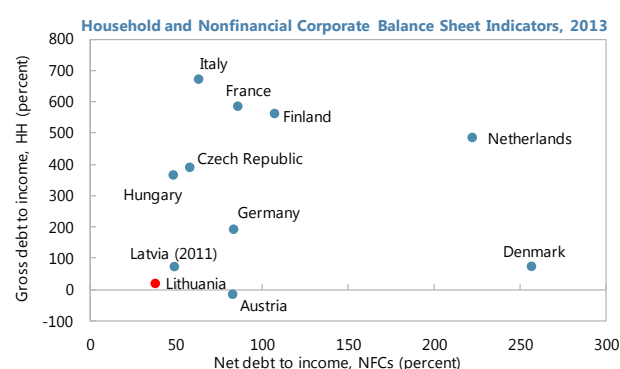
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CONTEXT

1. With euro adoption in January, Lithuania turned the page on the period of adjustment that followed the 2008/09 crisis. Growth was among the strongest in Europe in recent years, lifting real GDP above its previous peak and bringing per-capita income to 73 percent of the EU average (in PPP terms). Internal and external imbalances have corrected, with unemployment below its historical average and the current account in slight surplus. Households' and companies' balance sheets are generally healthy; the loan-to-deposit ratio of the banking system has fallen well below 100 percent; and fiscal consolidation reduced the deficit to the debt-ratio stabilizing level. Euro adoption strengthened financial stability by securing access to ECB liquidity. It also came with important upgrades to policy frameworks, such as new fiscal rules, a fully fledged macroprudential toolkit, and banking supervision under the SSM. Overall, legacies from the boom-bust cycle are largely confined to the jump in public debt from some 15 to 40 percent of GDP and still subdued credit and investment.



Source: Eurostat.



2. The main policy challenge for Lithuania now is to successfully write the next chapter of convergence with living standards in Western Europe. This requires maintaining stability, notably securing fiscal space to deal with future downturns and spending pressures, and safeguarding the strong external position as wages converge and growth of domestic demand outstrips that of foreign demand. But more is needed to fulfill Lithuania's aspirations: only higher investment, more innovation, and structural reforms to make the most of demographically declining labor resources can underwrite sustained and rapid economic growth.

3. Far-reaching proposals for a new social model were tabled in March, ahead of general elections next fall. Since taking office in late 2012, the left-leaning coalition government led by the Social Democrats accomplished euro adoption, further advanced fiscal consolidation through expenditure restraint, and continued with energy sector reform, including diversifying gas supplies with the opening of Lithuania's LNG terminal in late 2014. Geopolitical tensions surrounding the situation in Ukraine prompted the reintroduction of the draft and a phased doubling of defense spending to 2 percent of GDP by 2020. Apart from defense issues, the policy focus is on completing other projects to diversify energy supplies, fighting the shadow economy, and helping firms open

new export markets to substitute for losses in the CIS. In March, the government unveiled for general consultation a reform package dubbed the “new social model” that proposes a new labor code, pension reform, and adjustments to social benefits and employment support programs.

RECENT DEVELOPMENTS

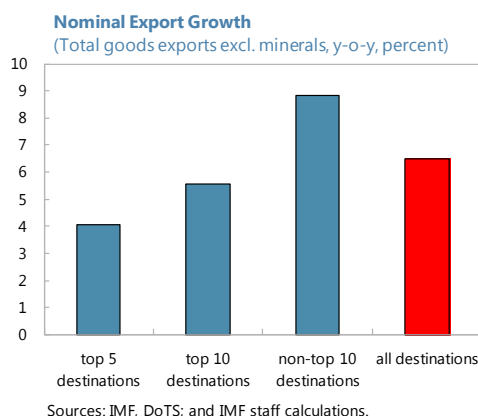
4. Growth remained resilient despite a challenging external environment. Solid growth of 2.9 percent in 2014 was mostly driven by domestic demand, as robust wage growth and generally improving labor market conditions spurred consumption. Unemployment fell to 9.6 percent in the second semester of 2014—the lowest since the crisis—and vacancy rates rose. Investment picked up strongly in early 2014 from post-crisis lows amid high capacity utilization, but slowed sharply again in the second half of the year as Russian import bans and the incipient Russian recession weighed on business confidence. Despite the difficult external environment, exports have held up reasonably well so far, reflecting in part a successful diversification drive into new markets.

Exports to Russia in Perspective			
	Nominal Growth (percent) 2014 vs. 2013	Nominal Growth (percent) 2014:H2 vs. 2014:H1	Share in GDP (percent)
Total exports of goods	-0.5	12.6	67.4
o/w of Lithuanian origin 1/ 2/	5.4	4.7	28.7
o/w under sanctions 1/ 2/	3.9	-1.7	3.8
Goods exports to Russia	4.4	13.7	14.1
o/w of Lithuanian origin 1/ 2/	-16.3	-4.1	1.6
o/w under sanctions 1/ 2/	-37.3	-69.5	0.4

1/ Excludes exports of oil products, which are volatile.

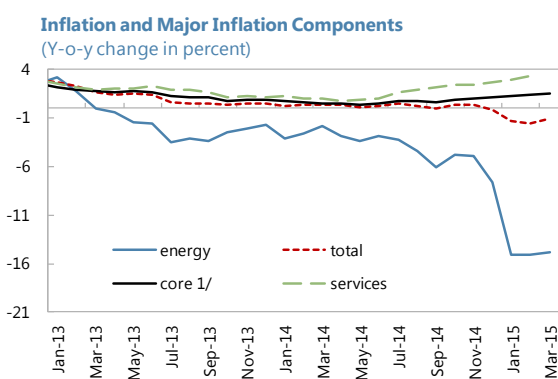
2/ Exports of Lithuanian origin exclude re-exports.

Sources: Haver, Statistics Lithuania, and IMF staff calculations.

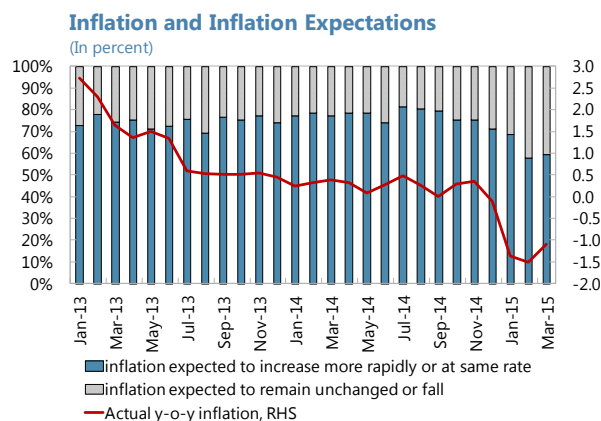


5. Inflation averaged a mere 0.2 percent in 2014 and has been negative since December, reflecting mostly external factors. Falling global energy prices and a 20 percent discount on natural gas imports from Gazprom drove energy price inflation deeply into negative territory. Imported deflation and falling world food prices also pulled down prices. Core inflation has been below 2 percent for the last two years, but currently runs some 50 bps higher than in the euro area, due to relatively fast-growing purely domestic price components, such as services, and is broadly in line with historical patterns.¹ The risk of debt deflation dynamics taking hold in Lithuania is remote, considering stable inflation expectations, strong wage growth, and generally healthy balance sheets.

¹ See IMF Country Report No. 14/114 for an analysis of historical inflation differentials with the euro area and the role of the Balassa-Samuelson effect.



Sources: Haver; and IMF staff calculations.
1/ Core excludes energy, food, alcohol, and tobacco.



Sources: Haver; and IMF staff calculations.

6. External stability strengthened further with euro adoption. For the second year running, the current account recorded a surplus, reducing the external debt ratio and improving the international investment position. The trade balance worsened in 2014, reflecting an uptick in import growth on the back of strong domestic demand. But goods exports excluding oil grew at a robust 6.5 percent and strength in the income balance contained the erosion of the current account surplus. The external balance assessment estimates that Lithuania's current account and exchange rate are broadly in line with fundamentals (Box 1). Euro adoption removed a critical vulnerability previously associated the low reserve coverage under the currency board arrangement.

7. Fiscal consolidation advanced more than expected in 2014 with the deficit now reaching the debt-ratio stabilizing level.

The adjusted fiscal deficit improved to 1.2 percent of GDP in 2014 from 2.2 percent of GDP in 2013, corresponding to a fiscal structural improvement of 1 percent of GDP—double the amount envisaged in the budget.² Better local government and social security finances, as well as moderate spending underexecution, were responsible for the overperformance. VAT shortfalls persisted despite efforts to strengthen tax administration but were offset by buoyancy in other taxes. Public debt stabilized at some 40 percent of GDP. In line with Fiscal Compact requirements, a new fiscal rule with countercyclical elements and embedded expenditure rules was

Table. General Government Balance (In percent of GDP)

	2012	2013	2014
General government balance - ESA 2010	-3.1	-2.6	-0.7
<i>of which:</i>			
Deposit Insurance Fund (DIF) balance 1/	0.2	-0.4	1.3
Pension accruals 2/			-0.8
Adjusted general government balance	-3.3	-2.2	-1.1

1/ DIF balances fluctuate due to payouts to depositors and subsequent asset recoveries following the intervention in two domestic banks in 2011 and 2013, respectively.

2/ Compensation payments for past pension cuts on accrued basis.

² The adjusted fiscal deficit excludes one-off pension compensations and Deposit Insurance Fund balances. The Constitutional Court ruled that disproportionate pension cuts in the crisis years had to be compensated, costing 0.8 percent of GDP. The accrual impact is fully reflected in the 2014 deficit, but actual payments are spread over several years. Adoption of the ESA2010 accounting framework extended the coverage of the general government sector to include the Deposit Insurance Fund.

approved and will apply from next year's budget onward. Several rating agencies upgraded Lithuania's sovereign rating in the context of euro adoption.

Box 1. External Sector Assessment

The current account is balanced. External adjustment from current account deficits as large as 15 percent of GDP during the 2003–08 boom was primarily driven by export growth, rather than import compression, suggesting that it will be more easily sustained. Staff projects a gradual and moderate deterioration of the small 2014 current account surplus to a deficit of about 2 percent of GDP by 2020, as still subdued investment makes a fuller recovery and income convergence buoys consumption. It would be mostly financed by FDI.

The REER is broadly aligned with fundamentals. According to the EBA-lite methodology, the external position is currently appreciably better than the "norm" derived from fundamentals, but results need to be interpreted with caution. The EBA-lite approach does not capture well the pronounced boom-bust cycle that Lithuania and emerging Europe went through in the past decade. For example, because EBA-lite does not use backward-looking explanatory variables it makes no allowance for the fact that investment has been subdued for some time in the aftermath of the bust, to compensate for the excesses of the boom. Recovering investment should eventually weaken the current account even without much exchange rate adjustment. While staff also sees the current account in deficit in the medium term, the current account norm suggested by EBA-lite of -4.8 percent of GDP is on the high side—it would put external debt on an unsustainable path. Alternative exchange rate assessment methodologies find only a very small degree of exchange rate misalignment. A direct estimate of the equilibrium real effective exchange rate finds a small undervaluation of 3.6 percent. And compared to the exchange rate that would stabilize Lithuania's net foreign asset position, its exchange rate is marginally overvalued by 0.6 percent.

Summary Table

CA-Actual	0.2%	CA-Fitted	-4.2%
CA-Norm	-4.8%	Residual	4.4%
CA-Gap	5.0%	Policy gap	0.6%
Elasticity	-61.6%		0.0%
Real Exchange Rate Gap	-8.1%	Cyclical Contributions	0.2%
		Cyclically adjusted CA	0.0%
		Cyclically adjusted CA Norm	-5.0%

Gross external debt has come down significantly in recent years and now stands at 67 percent of GDP. Standard tests suggest that it would remain sustainable under a variety of adverse shocks (Figure 1A). Just over half of external debt is owed by the public sector, of which less than half in turn is denominated in currencies other than euros. Private external debt mostly consists of debt to parent banks or companies based abroad and should therefore not be at risk of disruptive withdrawal. The IIP stands at -44 percent of GDP, reflecting mainly the excess of inward over outward FDI and funding by parent banks of their Lithuanian affiliates.

8. Lithuania's largely Nordic-owned financial system has further strengthened, but a revival of credit remains pending. The CAR rose to 21.3 percent, the NPL ratio declined to 6.5 percent, and strong deposit growth continues, buoying the liquidity ratio, reducing loan-to-deposit ratios to 90.6 percent, and easing net liabilities to parent banks to 11 percent of GDP. The three largest banks easily passed the ECB's asset quality review and EBA stress tests. Financial sector profitability has been satisfactory in recent years, but performance varies across financial institutions. Supervisors are working closely with some smaller banks and the credit union sector (2½ percent of system assets) to guard against excessive risk taking and ensure sufficient capitalization, especially as the CAR rises to 10.5 percent this July following CRD IV transposition. Fundamental reform of the credit union sector along the lines suggested by the Bank of Lithuania is progressing with the proposal now under discussion in parliament. Supervisory coordination among Lithuanian, Nordic,

and European agencies is transitioning to the new setup under the SSM. While mortgage lending picked up ahead of euro adoption, corporate borrowing continues to contract. Overall private sector credit declined by 1.1 percent in 2014, amid subdued credit demand and credit standards that remain demanding, despite gradual loosening since 2012. Housing and equity valuations started improving from 2012, appreciating at annual average rates of 7 and 16 percent, but remaining around 35 and 20 percent below the peak levels reached at the height of the boom.

OUTLOOK AND RISKS

9. Past resilience augurs well for growth in 2015. Growth is projected at 2.8 percent, broadly unchanged from last year and led by domestic demand. Consumption will be underpinned by still-solid wage growth and lower energy prices, while external uncertainties will likely dampen investment. On the external front, improving prospects for the euro area and continuing efforts to diversify exports should largely counterbalance the negative drag from the recession in Russia and the CIS. Consumer price inflation is projected to average -0.3 percent on account of low energy and import prices. Lithuania will benefit from the ECB's QE program mostly indirectly through its effect on euro area activity and prices—eligible and available Lithuanian government securities amount to only a small fraction of the asset purchases apportioned to the Bank of Lithuania under the program and banks' lending policies are unlikely to materially change in the wake of declining sovereign yields.

10. Growth is expected to pick up to 3.2 percent in 2016 and to about 3¾ percent over the medium term, although this remains contingent on underpinning policy reforms. In the nearer term, a gradually improving external environment would be the main driver and the small output gap of currently -0.2 percent of GDP would close in 2017. For the medium term, potential growth has been estimated at 3¾ percent for the post-boom-bust period, compared to actual average annual growth of 4.4 percent during 1995–2014 (IMF Country Report No. 11/320). But attaining this growth rate will require structural reforms, especially those that lift investment back to historical norms, support employment to counteract worsening demographics, and boost innovation to alleviate slowing productivity growth as Lithuania's income gap with Western Europe narrows. Rising investment and income catching-up would push the current account into moderate deficit, which should be largely financed by FDI. Inflation is projected to pick up as the euro area moves out of deflation and should run at about 2½ percent in the medium term—slightly higher than in the euro area and in line with Lithuania's historical record and the Balassa-Samuelson prediction for catching-up economies.

11. Risks have moderated but remain tilted to the downside and relate mostly to external factors. Lithuania is a small and highly open economy, with exports corresponding to 80 percent of GDP. Trade with the EU dominates, but Lithuania is also an important gateway for trade with Russia and the CIS. A protracted period of slower growth in either set of trading partners would affect Lithuania through trade channels with knock-on effects on investment. Geopolitical tensions surrounding the situation in Ukraine could have stronger effects on confidence and investment than in the baseline if they became entrenched or escalated further. A surge in global financial volatility

may affect Nordic parent banks, which remain reliant on external funding and face domestic vulnerabilities, and could spill over to their Lithuanian affiliates. Insufficient investment and upgrading by Lithuanian companies could undermine medium-term growth prospects. On the upside, the boost to consumption from lower energy prices could be larger than assumed in the baseline.

12. The authorities broadly shared staff's views on outlook and risks. The Bank of Lithuania's growth projections are similar to those by staff while the Ministry of Finance sees upside potential to its somewhat more conservative baseline. Both assessed underlying fundamentals as strong, with the outlook mainly clouded by external uncertainty, although successful export diversification and upgrading in companies remained essential for prospects going forward. They saw little upside risk from low energy prices to their baselines, but some mentioned good absorption of EU structural funds and resources under the "Juncker Plan" as potential boons. Slow growth in trading partners and a further escalation of geopolitical tensions were highlighted as the main downside risks, with the latter also effecting the economy through the need to raise defense spending. Regarding global financial volatility and spillovers from Nordic cross-border banks, the authorities emphasized mitigating factors: limited reliance of Lithuanian subsidiaries on parent bank funding, strong home-country sovereigns, and access to ECB liquidity. Official inflation projections are close to those by staff and the authorities also assess risks of entrenched deflation as low, pointing to robust wage growth and the limited role that price developments have played in post-crisis wage bargaining.

Republic of Lithuania—Risk Assessment Matrix ^{1/}		
Risk	Relative Likelihood	Impact if Realized
<p>Side-effects from global financial conditions:</p> <p>□ A surge in financial volatility: As investors reassess underlying risk and move to safe-haven assets given slow and uneven growth as well as asymmetric monetary exit, with poor market liquidity amplifying the effect on volatility.</p>	High	Low/Medium Bank losses and funding stress in Swedish banks could spill over to their Lithuanian subsidiaries that account for the bulk of the banking system. But domestic deposit growth in excess of domestic credit growth should mitigate the impact on the Lithuanian economy.
<p>Protracted period of slower growth in advanced and emerging economies:</p> <ul style="list-style-type: none"> • Euro area and Japan: Weak demand and persistently low inflation from a failure to fully address crisis legacies, leading to “new mediocre” rate of growth. • Emerging markets: Maturing of the cycle, misallocation of investment, and incomplete structural reforms leading to prolonged slower growth. 	High Medium	High Lithuania would be affected through trade and investment channels. Trade with the EU dominates, but Lithuania is also an important gateway for trade with Russia and the CIS.
<p>Political fragmentation that erodes the globalization process and fosters inefficiency:</p> <p>□ Russia/Ukraine: the mounting conflict depresses business confidence and heightens risk aversion, amid disturbances in global financial, trade and commodity markets.</p>	Medium	Medium Would delay a needed pickup in investment and depress services associated with Russian transit trade.
<p>Insufficient technology upgrading and investment, undermining medium term competitiveness.</p>	Medium	Medium Delaying productivity enhancing investment would slow income convergence and erode competitiveness.
<p>^{1/} The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff’s subjective assessment of the risks surrounding the baseline (“low” is meant to indicate a probability below 10 percent, “medium” a probability between 10 and 30 percent, and “high” a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.</p>		

POLICY DISCUSSIONS

With euro adoption accomplished and supporting frameworks largely in place, discussions focused on policies to support the next chapter of convergence with living standards in Western Europe, to thrive in the currency union, and to ensure continued stability in the face of population aging and wage convergence with the EU. This will require some further budget consolidation and structural reform to secure fiscal space and address future spending pressure; a boost to investment and innovation; and structural reforms to make the most of shrinking labor resources. The authorities are open to Fund policy advice and have implemented many past recommendations (Box 2).

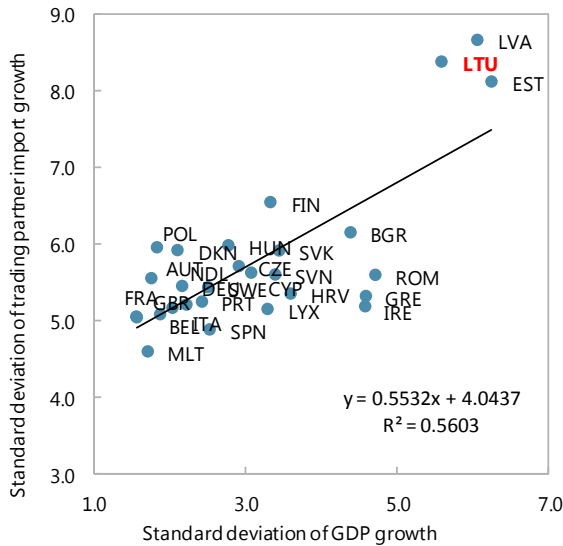
Box 2. Implementation of Past Fund Advice

- **Fiscal Policy.** The Fund's past advice has focused on public finance repair, putting in place countercyclical fiscal rules, and shifting from an expenditure-based consolidation toward more reliance on revenues, especially recurrent wealth taxes. Much consolidation has taken place and fiscal rules were strengthened in the context of euro adoption, but wealth taxes remain under discussion.
- **Financial Sector Policy.** The authorities have forcefully addressed weaknesses in smaller financial institutions—two domestic banks were intervened in 2011 and 2013—and supervision has tightened considerably for credit unions. The Bank of Lithuania has been given wide macroprudential powers, in line with past policy advice.
- **Other Issues.** Infrastructure projects in the transport and energy sectors are ongoing, with a welcome focus on more regional integration, along with continued governance improvements in the sectors' SOEs. Addressing the causes of high structural unemployment through training and tax reforms remains outstanding, but discussions started on modernizing the labor code and reforming employment support under the "new social model."

A. Securing Fiscal Space and Raising Public Sector Efficiency

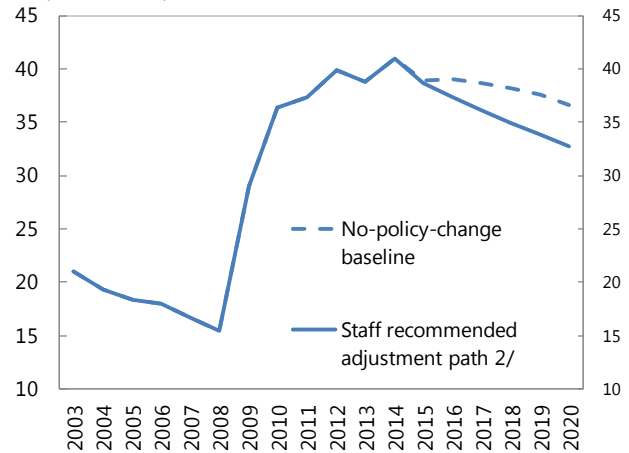
13. Lithuania needs ample fiscal space. Low fiscal deficits and debt would allow the authorities to let automatic stabilizers operate freely in downturns, smooth the business cycle, and avoid disruptions. In fact, business-cycle fluctuations have been among the largest in the EU, with Lithuania's small open economy highly exposed to volatility in trading partners and lacking an independent monetary policy to cushion downturns. Low public debt would also provide a valuable buffer against future fiscal costs of aging, which are estimated to add 3.4 percent of GDP annually to public spending by 2050. Determined fiscal consolidation since 2009 has now arrested the rapid rise in the public debt ratio, but some further sustained deficit reduction is recommended to put debt firmly on a downward trajectory and avoid a pattern of rising debt ratios in bad times and merely stabilizing debt ratios in good times. Staff suggested targeting a fiscal (structural) balance of -0.5 percent of GDP, which would reduce the debt ratio by a cumulative 5 percent of GDP over the next five years (as opposed to just 1 percent of GDP in the absence of further consolidation).

Volatility GDP and Trading Partner Import Growth
(In percent, during 1995-2014)



Sources: IMF, WEO; and IMF staff calculations.

General Government Gross Debt, 2003-20^{1/}
(Percent of GDP)



Sources: Eurostat; Ministry of Finance of Lithuania; and IMF staff calculations.
1/ The spike in debt in 2014 reflects pre-financing of a bond redemption in January 2015 in the amount of US\$1.5 billion (3.1 percent of GDP).
2/ Assumes a constant structural balance in 2015; consolidation of 0.3 percent of GDP in 2016 to reach a structural balance of -0.5 percent of GDP; and a structural balance of -0.5 percent of GDP in all subsequent years.

14. For 2015, a neutral fiscal position is broadly appropriate. An unchanged structural fiscal balance this year is sufficient to keep the schedule for structural deficit targets on track because of last year’s fiscal overperformance. The implied neutral stance is the minimum required under the SGP, broadly appropriate for Lithuania considering the still slightly negative output gap, and in line with the Fund’s euro area wide fiscal advice. Nonetheless, measures of 0.4 percent of GDP are required to avoid fiscal backsliding, because spending plans and revenue policies in the budget were drawn up based on more favorable macroeconomic assumptions than are projected now. Paring back discretionary spending in line with lower inflation could make a limited contribution. Expanding wealth taxation should be considered, as previously recommended by the Fund. Untargeted expenditure cuts would clearly be a second best option.

15. Beyond this year, limited further consolidation is recommended, but various pressures on public finances will need to be addressed. If the structural balances is kept constant this year, additional moderate consolidation of 0.3 percent of GDP would be sufficient to reach the recommended target structural balance of -0.5 percent of GDP in 2016. Nonetheless, fiscal policy makers will face challenges: expenditure compression undertaken since 2009 could start to unwind, rising incomes will lead to additional demands on the public sector, and higher defense expenditure is already committed. In the longer run, aging-related fiscal costs will escalate.

16. A fiscal structural reform plan could provide useful strategic direction for tackling pressures and help improve public sector efficiency more generally. Lithuania’s expenditure and revenue ratios are the lowest in the EU, labor taxation is high, the demographic outlook is among the most challenging in Europe, and results of public spending programs have disappointed in several areas. Fiscal structural reform should therefore focus on six priorities:

- **Developing underutilized tax bases.** Wealth taxes, such as real estate taxes or car taxes, currently yield little revenue or do not exist, yet are less distortive than other taxes.³ Energy excises are also low by European standards.
- **Strengthening tax administration.** Tax administration reforms have improved excise collections, but there is little evidence that the VAT compliance gap has narrowed since the EC calculated it as one of the largest in the EU in 2011.⁴
- **Reducing the tax burden on labor.** As revenues from other taxes improve, labor taxes should be cut to support job creation and to reduce incentives to work in the black economy or remain inactive.⁵
- **Reducing spending inefficiencies.** An IMF staff review of public expenditure found numerous areas where spending deviates from EU benchmarks and outcomes are subpar (Box 3). One source of inefficiency is oversized infrastructure in education and relatively high government employment. In the longer run the size of the public sector should also be linked to the declining population.
- **Reforming pensions.** Old-age pensions need to be made fiscally and socially sustainable, primarily by linking the statutory retirement age to longevity. Excessive recourse to disability pensions needs to be addressed through tighter enforcement of eligibility restrictions.
- **Better monitoring local government finances.** Local government finances were responsible for negative surprises in 2013, although they improved in 2014 in most municipalities. A recent IMF technical assistance mission highlighted the need for better monitoring and forecasting, along with a stronger legal framework.

³ For a discussion of Lithuania's tax system compared with EU peers, see Country Report No. 13/82.

⁴ In 2011, the EC estimated Lithuania's VAT compliance gap at 4.4 percent of GDP, compared to 3 percent of GDP for emerging Europe on average and 1.9 percent of GDP for Estonia. Since then, VAT receipts have grown by 11 percent and the VAT base by 18 percent, suggesting that the gap has widened further.

⁵ For a discussion of supply-side distortions and inactivity traps, see Country Report No. 14/117.

Box 3. From Expenditure Consolidation to Expenditure Efficiency¹

Years of spending restraint have left Lithuania with the EU's lowest spending-to-GDP ratio. Extensive crisis-induced spending cuts successfully brought Lithuania's public finances under control, but spending quality may have suffered. Moreover, pressures are likely to emerge going forward as demands on the public services increase with rising incomes and as the population ages.

IMF staff's review of public expenditure seeks to identify areas where spending efficiency and sustainability can be improved. The analysis benchmarks spending in Lithuania against that in other European countries, adjusted for differences in per-capita income. It considers levels and composition of public expenditure according to economic and functional classifications. It also relates them to outcomes to get a sense of spending quality.

The main findings are as follows:

- **First, Lithuania's spending level and spending structure differ widely from EU benchmarks.** Benchmarking a cross-classification of functional and economic categories shows that relative under-spending is widespread. It is most pronounced in outlays for goods and services (except for education) and social protection spending (driven by low old-age pensions). But there are also areas where spending exceeds that of EU peers, prominently in education, health sector wages, and sickness and disability benefits.
- **Second, public services can be improved by prioritizing quality over quantity in the wage bill.** Although the public wage bill as a share of GDP is similar to the EU benchmark, public employment levels are relatively high and average public sector wages relatively low, which raises questions about the public sector's ability to attract and retain qualified staff. Linking reform of public employment to future wage increases could help improve efficiency and contain pressures on the wage bill.
- **Third, social spending may be unsustainably low.** Social spending below the EU benchmark likely contributes to Lithuania's high income inequality. Low old-age pensions may create spending pressures as the population ages. Sustainability of the pension system can be improved and inequality alleviated through parametric reforms (such as increasing the retirement age), better targeting of non-pension spending (such as increased use of means-testing of social assistance), reducing high spending areas (such as disability benefits), and raising gross pensions but subjecting them to more progressive income taxation.
- **Fourth, education outcomes are below par despite high spending.** Data point to low and declining student-teacher ratios and class sizes, poorly targeted financing, and mismatches between fields of study in tertiary education and labor market needs. Rationalizing resources according to the number of students served could help reduce spending and improve quality over time, including through school consolidation and a gradual reduction in the number of teachers.
- **Fifth, health outcomes are poor despite public-sector health spending comparable to the EU benchmark.** Moreover, population aging is set to exert spending pressures. These could be alleviated by strengthening the role of preventive and primary health care and reducing spending on far more expensive tertiary care.

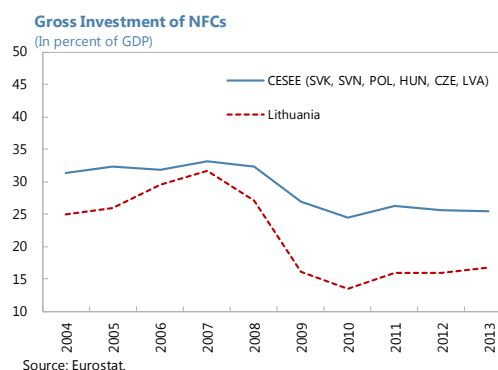
¹ Based on Selected Issues Paper "From Expenditure Consolidation to Expenditure Efficiency: Addressing Public Expenditure Pressures in Lithuania," prepared by David Coady (Fiscal Affairs Department) and Nan Geng (European Department).

17. The authorities broadly concurred with staff’s recommendations. They are committed to avoiding a widening of the fiscal deficit in 2015, but count on tax administration improvements and budget underexecution rather than tax increases to achieve it. Their fiscal policy will be guided by national and European rules for the MTO, which should result in a reduction of the public debt ratio similar to the one advocated by staff. They welcomed the idea of a strategy for fiscal structural reform as a roadmap for policy decisions, but noted that strengthening wealth taxation remained politically difficult. They found staff’s review of public expenditure very helpful in identifying areas for reform and agreed with the urgency of addressing inefficiencies in education and health. Savings associated with the recent decentralization of social assistance to municipalities demonstrated the large scope for efficiency gains in public spending programs.

B. Fostering Investment and Innovation

18. Private investment needs to recover more fully to sustain future income convergence.

Public investment held up well through the crisis, thanks to good absorption of EU structural funds in the 2007–13 framework. But private investment has not fully recovered from the setback in 2009, even when excluding housing investment. It is now 3 percent of GDP below Lithuania’s historical average—a gap that reduces growth by an estimated $\frac{3}{4}$ percentage points annually if unaddressed. The boom-bust experience has left investors and banks risk averse, the geopolitical situation weighs on investment sentiment at the moment, and the challenging demographic outlook may also make potential investors cautious.



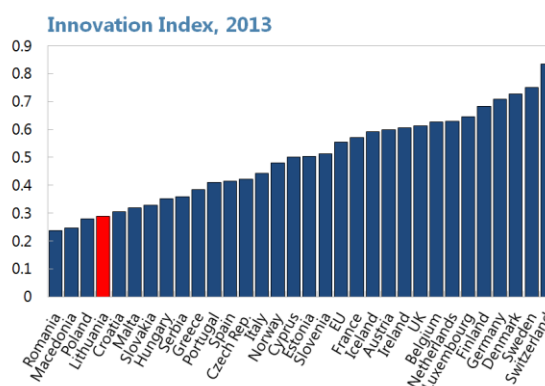
19. Government support for SME investment is welcome. Access to financing is currently not a generalized binding constraint for investment, according to surveys and discussions with banks and company representatives. But with banks very much focused on low risk and established clients, SMEs find it more difficult than usual to obtain bank financing—19 percent of SMEs reported access to financing as their most pressing problem, compared to 13 percent in the EU as a whole. The government will again use EU structural funds to facilitate and leverage SME financing, relying on a variety of financial instruments, such as loans, guarantees, and venture funds. These support programs have had a good track record so far, but continued care is needed to ensure that genuine market failures are addressed and support for unviable businesses is avoided.

20. Prefinancing of projects under the 2014–20 EU financial framework and the “Juncker Plan” could provide a useful jolt to investment this year and next. The authorities have undertaken to prefinance from national sources projects likely to receive EU support under the 2014–20 framework later on. This helps advance EU-supported private and public investment into 2015, ahead of the new framework coming fully on stream. The authorities are also preparing to secure resources for investment under the EU-wide “Juncker Plan” when it becomes operational later this year. A modern public-private-partnership framework is in place to carry out infrastructure

investment projects under the “Juncker Plan,” although it is not yet integrated into the budget cycle and has so far been utilized only for a handful of projects.

21. To remain competitive globally, Lithuanian businesses need to continue to innovate and modernize, and a more unified policy approach could help in this regard. Innovation broadly defined as the introduction of new or significantly improved products, processes, marketing methods, or organizational practices is key for the Lithuanian economy to narrow the income gap with Western Europe. But according to the European Commission’s innovation scorecard, Lithuania is only a moderate innovator and trails particularly in the critical category of innovation outcomes. Lithuania’s new “smart specialization strategy” aims to focus innovation promotion on promising areas. But more attention needs to be paid to overcoming fragmentation between ministries, numerous implementation agencies, and various advisory bodies, which can lead to duplication of efforts and infrastructure, undermine critical mass, and complicate decision making.

22. Prospects for investment and innovation will also depend on sustainable wage developments and structural reforms to keep the business environment attractive. While wage growth has under or overshoot productivity gains at times, Lithuania has a favorable track record of sustainable wage developments: gaps between wage and productivity developments tend to self-correct over time and Lithuania’s labor share of income is in line with fundamentals (Box 4). Rapid wage growth in the past two years reflects catching-up with faster productivity growth in the preceding crisis years—a process that has largely run its course by now, meaning that wage growth is likely to slow to a pace more consistent with that of productivity going forward. Regarding structural reforms, the focus should be on making the most of shrinking labor resources so that investment and innovation are not hampered by the lack of suitable staff (see below).



Source: European Commission.

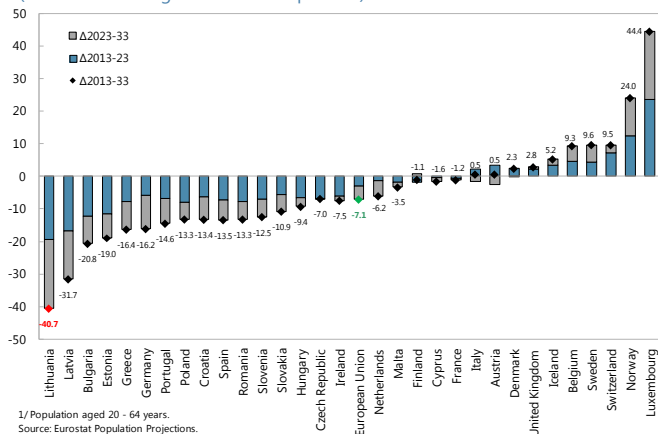
23. The authorities saw EU structural funds and “Juncker Plan” resources as the main available avenues to support investment in the short run. They agreed that productivity growth supported by investment and innovation was critical for the next stage of income convergence. Diminished business opportunities in Russia and the CIS currently weighed on investment, but high capacity utilization was a potential upside to the investment outlook. They doubted that QE or substituting capital market for bank financing of large firms would spur investment through portfolio rebalancing effects, i.e., entice banks to finance riskier projects. This left deploying EU resources in support of investment as the main policy lever, as the EU 2014–20 financial framework comes fully on stream in the next 12 months. They agreed that wages in Lithuania remained competitive and should not hold back investment. There could be somewhat more room for wages to catch up with past productivity gains than estimated by staff.

C. Raising Productivity through Structural Reforms

24. A rapidly declining workforce makes it imperative to make the best possible use of it.

Eurostat projects that the decline of Lithuania’s working-age population will accelerate from just under 1 percent per year during 1995–2014 to just over 2 percent annually over the next decade, with migration being the main driver as young and mostly high-skilled Lithuanians seek better opportunities abroad. Worsening demographics would reduce growth by an estimated ½ percent per year unless addressed by efforts to boost labor force participation and to make the most of available labor resources more generally.

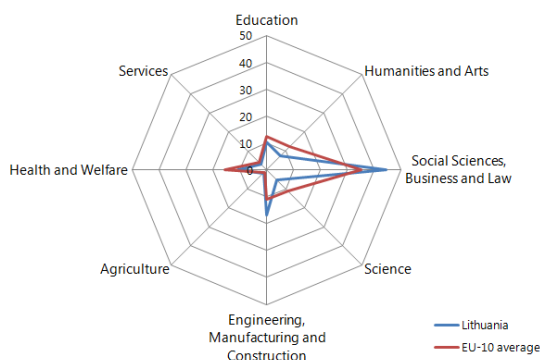
European Countries: Working-Age Population, 2013-33^{1/}
(Cumulative change since 2013 in percent)



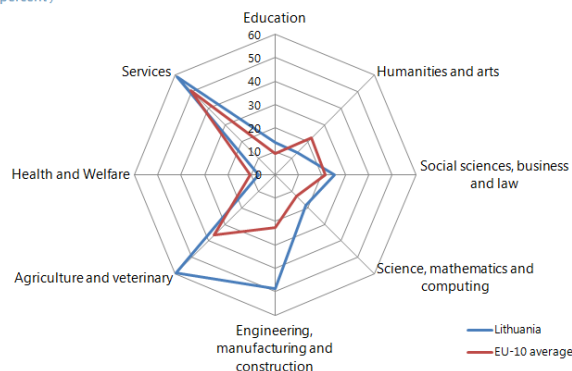
25. The large mismatch between the skills provided by Lithuania’s education system and those sought in the labor market needs to be resolved.

Tertiary enrollment rates are very high—over 50 percent compared to an EU average of 37 percent—while vocational training is underdeveloped and overly school-based. Recent legislative changes to roll out apprenticeship programs more widely are encouraging, but following through with the necessary regulations and implementation will be essential. Within tertiary education, there is a bias toward studying social sciences, law, and business administration—they account for 44 percent of graduates compared to 37 percent for the EU on average. As a result, occupational mismatch is high, with 31 percent of workers occupied in a field other than that of their study, compared to 23 percent for the EU on average. It will be important to address overcapacity in tertiary education, which is set to grow further with the decline in the student-age population, improve students’ information about job market opportunities, and review financial incentives and quality standards for educational institutions.

Percentage of Graduates from Tertiary Programs by Study Field, 2012 or Latest (In percent)



Education-Occupation Mismatch (ISCED 5-6) of Persons aged 25-34 by Tertiary Study Field, 2012 or Latest (In percent)



Source: UNESCO.
Note: EU-10 average includes countries in the bottom quartile of average youth unemployment during 2000-2012. (Austria, Cyprus, Denmark, Germany, Greece, Iceland, Ireland, Luxembourg, Netherlands, and Norway). Education-occupation mismatch is calculated as the percentage of persons aged 25-34 employed in a field that they did not graduate in.

26. The proposed new labor code could modernize labor relations and improve labor utilization. Lithuania's labor market is generally flexible, but the current code is outdated, rigid, and poorly applied. Concrete proposals for a new code in the context of the "new social model" are welcome. Proposed reforms envisage more realistic rules for overtime, notice periods, and severance pay that would remove key obstacles for foreign investors, thereby fostering the creation of relatively well-paying jobs and mitigating emigration pressures. Domestic firms would have fewer incentives for informality, with productivity benefiting. Modern rules for part-time employment and job sharing under consideration could increase labor force participation. Explicit provisions regarding training, along with more cooperative labor relations through improved wage transparency, dispute resolution, and labor representation in companies, should also help raise labor productivity.

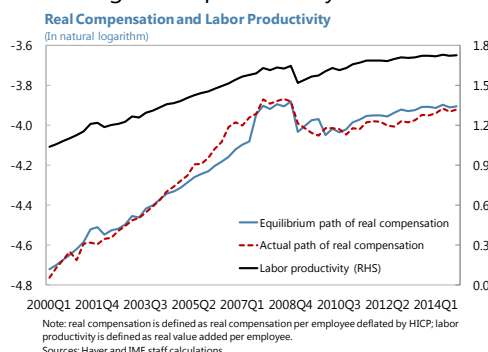
27. Reforms of pensions and labor taxation could also support better labor utilization, but need to be carefully planned and costed. Further increases of the statutory retirement age, once the ongoing raise to 65 years for men and women is fully phased in by 2026, could make a significant difference, especially if control over disability pensions is simultaneously strengthened. Cuts to labor taxes would improve incentives to work, help overcome benefit traps, and reduce informality. The "new social model" contains proposals in these regards that should be further developed, to ensure optimal design, long-term fiscal and social sustainability, and budgetary affordability.

28. In other structural reforms, further improvement of public enterprise governance is welcome. Cost effectiveness in Lithuania's public enterprises is important, considering these entities' key role in large infrastructure projects, especially in the energy sector. Good progress has been made with the prerequisite governance and transparency arrangements: representation of independent directors on boards has now reached at least one third in all large limited liability SOEs; accounting has been separated between commercial activities and public service obligations; and recent legislation extends requirements for independent directors to other large state entities and municipal enterprises. However, SOE return on equity has not changed much since 2013 and at 2½ percent remains below the government's 5 percent target.

29. The authorities appreciated the mission drawing attention to challenges related to labor resources. Important steps in reforming vocational training had already been taken and reform of higher education, including changes to university financing, is under discussion. However, reforms in these areas were complex and had far-reaching implication for various stakeholders. Regarding the "new social model," the government had decided to release the proposals developed by the expert group commissioned by the Ministry of Labor and Social Affairs for general consultation, with the labor code now debated in the tripartite counsel comprising labor unions, the government, and employer organizations.

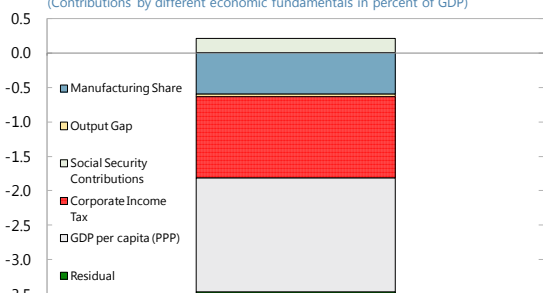
Box 4. Wages and Productivity¹

In Lithuania, wages and productivity tend to grow broadly in tandem, suggesting that wage determination works well and developments are sustainable. Wages and productivity should co-move for productivity improvements to be shared among the factors of production. Testing the relationship between real wages and real labor productivity empirically with Lithuanian data for 2000:Q1-14:Q4 shows that the co-integration relationship indeed holds. The transmission of productivity to wage growth is close to one in the long run. Short-run deviations from this relationship tend to self correct, according to an error correction model. Wages lagged productivity in the early post-crisis years but then started catching up.



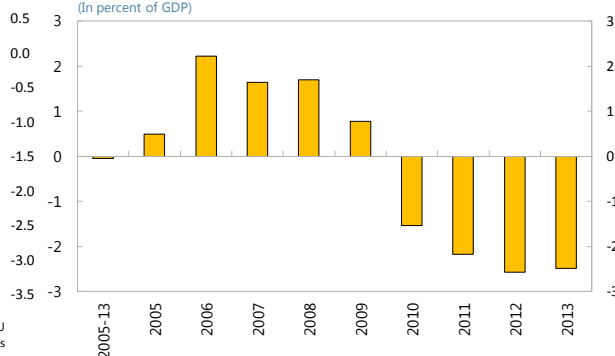
Analysis of the labor share of income confirms the long-run alignment of wage and productivity developments and the self-correction of transitory deviations. The labor share of income can be interpreted as the ratio of real wages to real productivity. Lithuania’s labor share of income of less than 40 percent of GDP may appear low at first, but a fixed-effects cross-country panel regression finds that it is in line with fundamentals, such as per-capita GDP, the share of the manufacturing sector, and the tax structure. The analysis also shows that Lithuania’s labor share of income somewhat exceeded its fundamental value in the boom period, overcorrected in the subsequent bust, and has since been gravitating back to the level suggested by fundamentals.

Difference Between Labor Income Share in Lithuania and the EU
(Contributions by different economic fundamentals in percent of GDP)



Sources: Haver, and IMF staff calculations. Note: Figure depicts the contributions of factors to the difference between the labor income share in Lithuania and the labor income share in the other 27 EU countries (average across countries and 2005-13). The contributions of macroeconomic fundamentals are calculated as the difference between the value of the fundamental in Lithuania and that in other countries multiplied the estimated coefficient from the cross-country fixed-effect panel regression.

Unexplained Residual
(In percent of GDP)



The key to solid wage growth lies in productivity growth, which in turn can be boosted by innovation. With wage determination working well and reflecting fundamentals there is no need for policy intervention—one-size-fits-all wage policies could even be counterproductive considering the large heterogeneity of productivity across sectors and firms. Policies to foster innovation are the more promising path to better wages. Cross-country firm-level data collected in the EBRD’s Business Environment and Enterprise Performance Survey (BEEPS) shows that more innovation is associated with higher productivity. And higher productivity should result in higher wages over time.

¹ Based on Selected Issues Paper “It Takes Two to Tango: Wages and Productivity in Lithuania” prepared by Qianying Chen and Greetje Everaert (both European Department).

STAFF APPRAISAL

30. Strong economic fundamentals and recent resilience to adverse external factors bode well for the near-term economic outlook. Legacies from the 2008/09 crisis have been largely worked off, with external and internal balance in place, strong public finances, private-sector balance sheets generally healthy, and policy frameworks strengthened in the context of euro adoption. Good economic performance despite adverse events in the CIS once again underscores the resilience and flexibility of the Lithuanian economy. Risks have moderated but remain tilted to the downside and relate mostly to external factors.

31. Over the medium term, convergence with living standards in Western Europe will depend critically on advancing the structural reform agenda. Investment needs to increase back to historical norms, labor resources should be better utilized to mitigate the drag from worsening demographics, and more innovation is required in support of moving up the value chain and remaining competitive as wages converge toward EU levels. Contingent on such reforms, growth could rise to 3¾ percent over time.

32. Fiscal consolidation is almost complete but past gains need to be preserved to build more fiscal space over time. Public finances overperformed last year, but it will take measures of 0.4 percent of GDP to keep the fiscal deficit from deteriorating this year. The implied neutral stance is the minimum required under the SGP and broadly appropriate for Lithuania, considering the still slightly negative output gap. Moderate further consolidation of 0.3 percent of GDP next year would deliver the staff-recommended target for the fiscal structural balance of -0.5 percent of GDP, ensuring a steady but gradual decline of the public debt ratio over time, thereby regaining fiscal space needed to be prepared for future adverse shocks.

33. Fiscal structural reforms could usefully defuse future spending pressures, raise spending quality, and improve tax efficiency. Wealth taxes and tax administration should be strengthened to create room for lightening the labor tax burden, spending programs with subpar results should be reformed, and areas subject to likely future spending pressures should proactively be tackled. Formulating a coherent fiscal structural reform strategy could catalyze progress.

34. The stability of the largely Nordic-owned banking system has further strengthened, with increased capitalization, lower NPLs, high liquidity, and adequate profitability. Access to ECB liquidity and SSM participation are newly gained additional safeguards. But supervisors need to persevere with efforts to strengthen some smaller domestic banks and credit unions with higher risk profiles and lower capitalization. Plans to fundamentally reform the credit union sector are welcome.

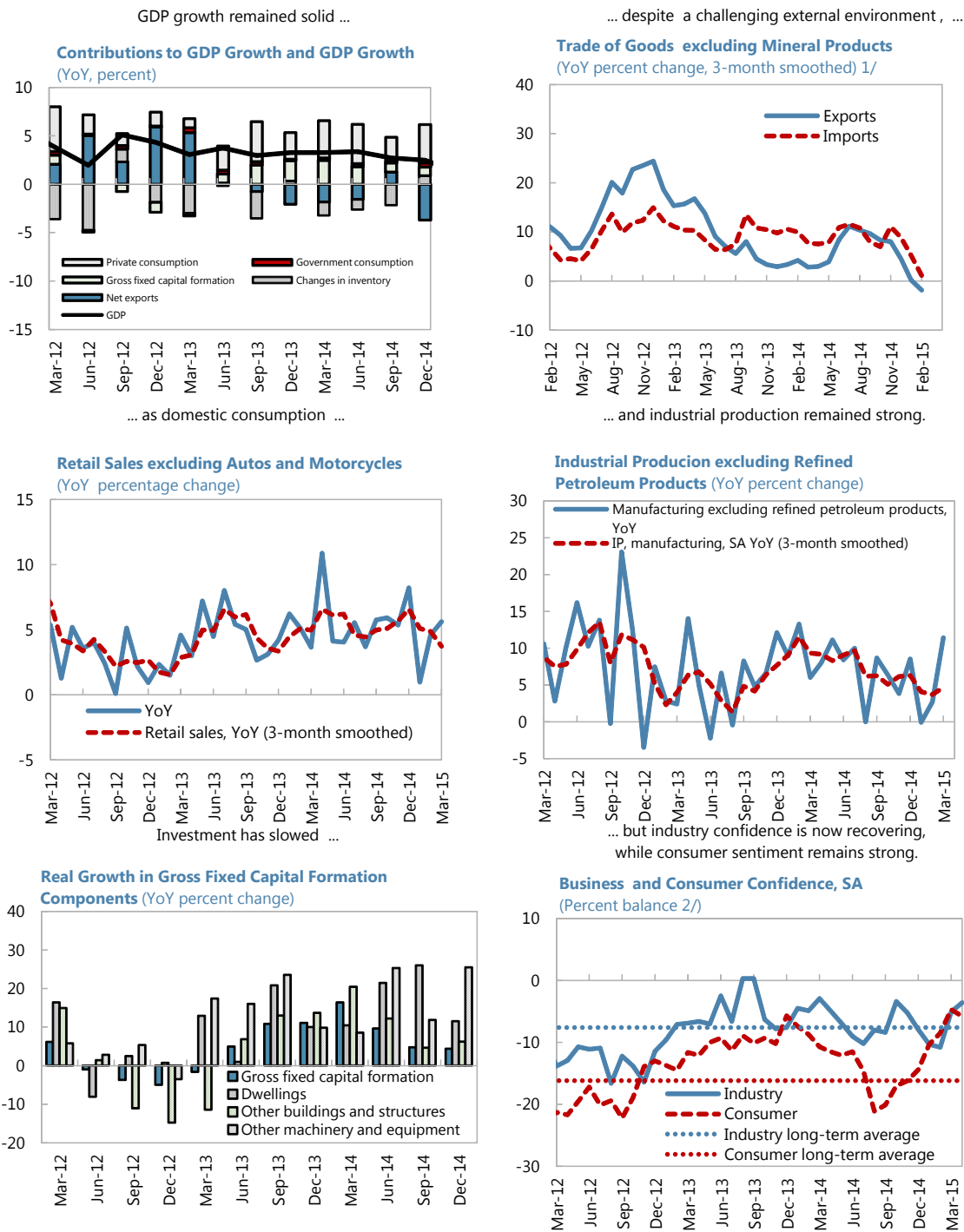
35. More private sector investment and innovation are needed to securely underpin continued income convergence. The lack of rebound in private investment after the 2008/09 crisis, still sluggish credit developments, and relatively poor innovation performance need to be addressed. Efforts to utilize EU funds and resources under the “Juncker Plan” are welcome, especially to the extent they benefit SMEs, which have a hard time securing financing from risk averse banks.

The effectiveness of innovation policies would benefit from reducing fragmentation in the current setup. An improved outlook for the availability of qualified labor would spur investment and innovation indirectly.

36. Making the best possible use of available labor resources in the face of adverse demographics is of paramount importance. Proposals for reforming the labor code are an opportunity to modernize labor relations and improve labor utilization. Education reform is of the essence to equip the labor force with a skill mix that better matches companies' needs.

37. It is recommended that the next Article IV Consultation be held on the 12-month cycle.

Figure 1. Republic of Lithuania: Real Sector Developments



Sources: Haver; Lithuania Statistical Office; and Bank of Lithuania.

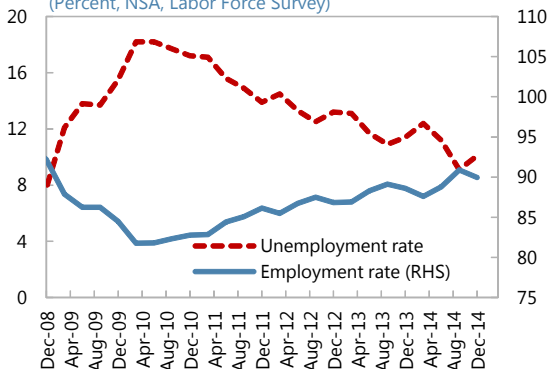
1/ The export and import data are measured in terms of F.O.B. and C.I.F., respectively.

2/ Percent balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease.

Figure 2. Republic of Lithuania: Labor Market and Competitiveness Developments

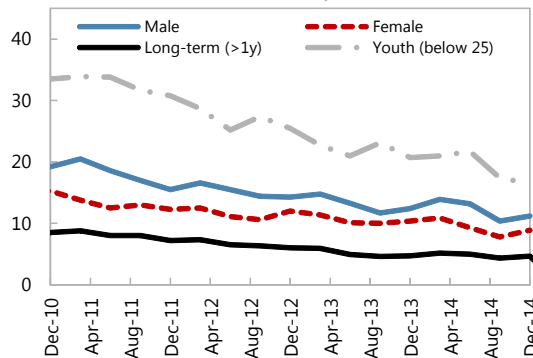
Unemployment continues to fall...

Employment and Unemployment Rate
(Percent, NSA, Labor Force Survey)



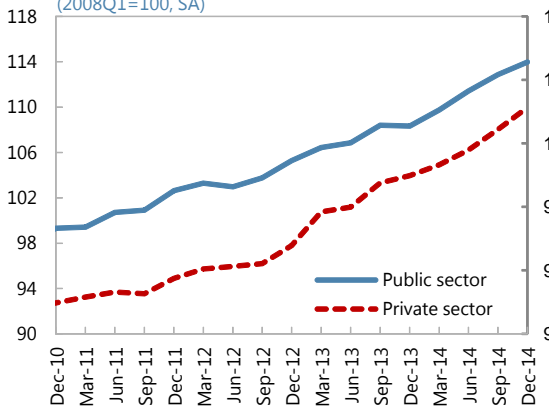
... but it remains high, especially for youth.

Unemployment Rate by Sex and Duration
(Percent, NSA, Labor Force Survey)



Nominal wages are increasing, especially in the private sector

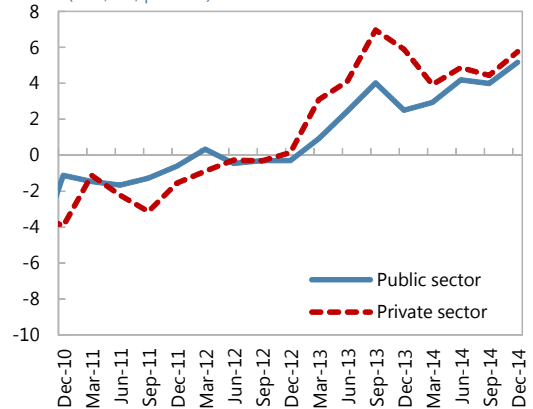
Average Monthly Gross Earnings
(2008Q1=100, SA)



Wage increases have not outpaced productivity so far, improving real effective exchange rate indicators.

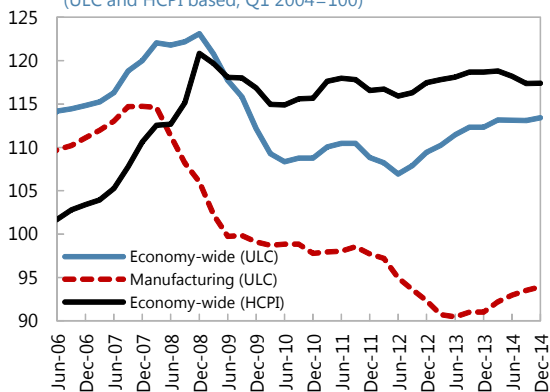
... and, amid low inflation, results in steady real wage growth.

Average Monthly Gross Real Earnings Growth Rate
(YoY, SA, percent)

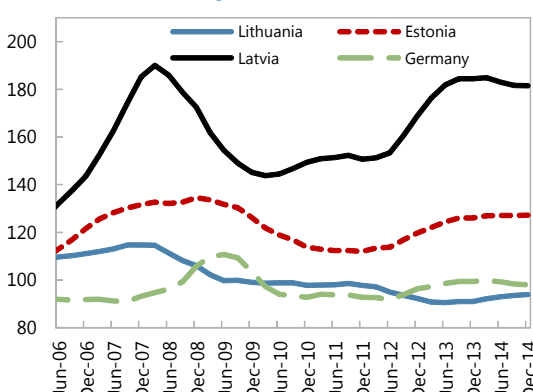


This is especially true for the manufacturing sector, where the REER has depreciated.

Real Effective Exchange Rate (REER)
(ULC and HCPI based, Q1 2004=100)



REER in Selected Countries
(ULC manufacturing based, Q1 2004 = 100)

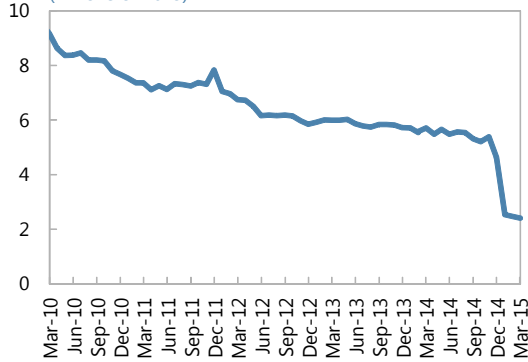


Sources: Haver; Eurostat; Lithuania Statistical Office; and IMF staff estimates.

Figure 3. Republic of Lithuania: Banking Sector Developments

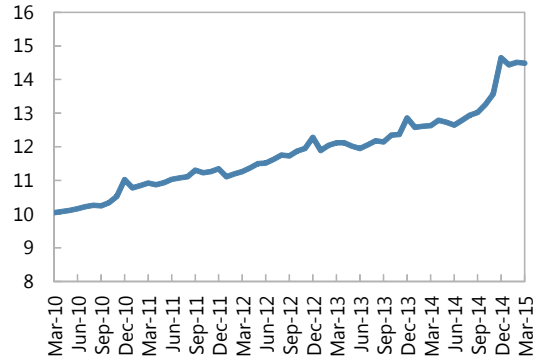
External funding has continued to decline ...

Banks' External liabilities 1/
(Billions of Euro)



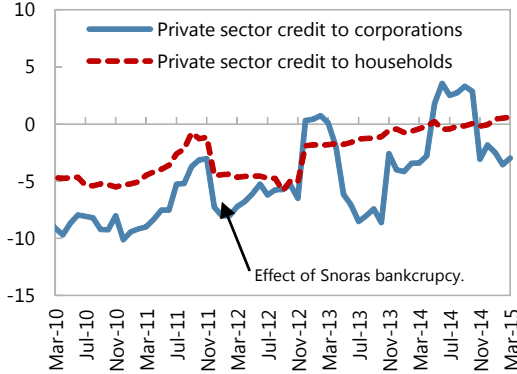
... while deposits have continued to increase robustly.

Total Deposits of Corporations and Households
(Billions of Euro)



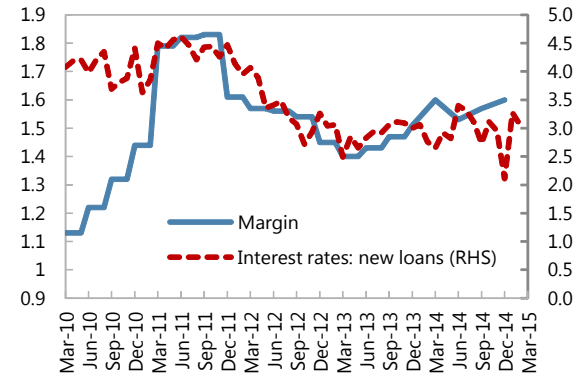
Credit may be staging a tepid recovery.

Credit Stock
(YoY percent change)



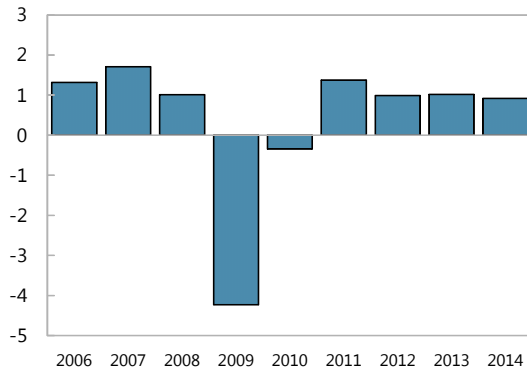
Rising interest rates margins ...

Interest Margins
(Percent)



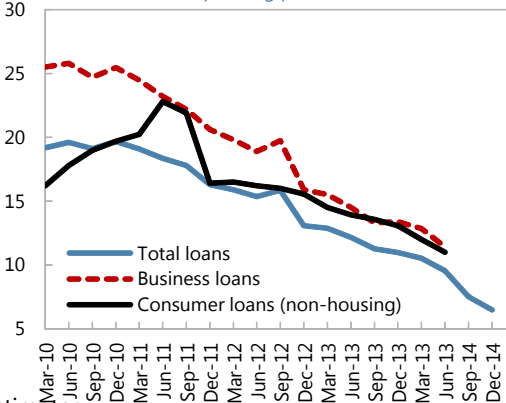
... are supporting profitability.

Return on Assets
(Percent)



Meanwhile, NPLs continue to decline.

Non-performing Loans
(Percent of corresponding portfolio)



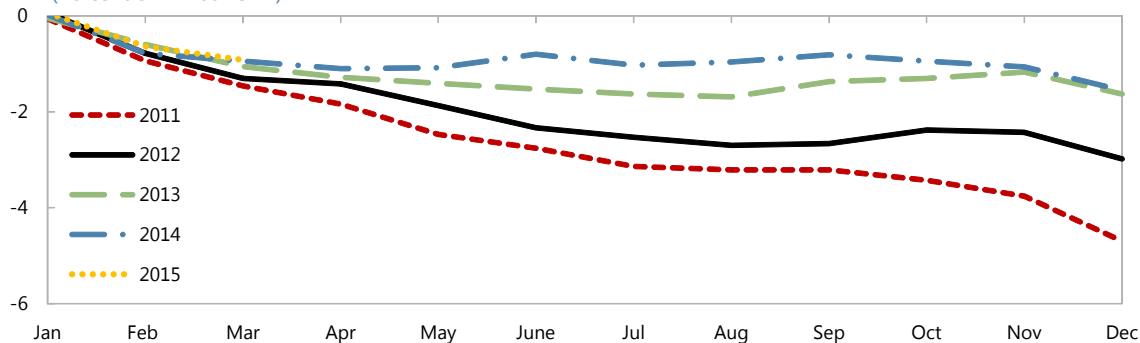
Sources: Dx Time; Bank of Lithuania; and IMF staff estimates.

1/ From January 2015 onwards, banks' external liabilities are redefined as those towards non-euro area countries.

Figure 4. Republic of Lithuania: Fiscal Sector Developments

The central government cash deficit stayed unchanged in 2014 despite the fact that more PIT resources went to local governments and there were above-budget one-off pension compensation payments (0.1 percent of GDP). ...

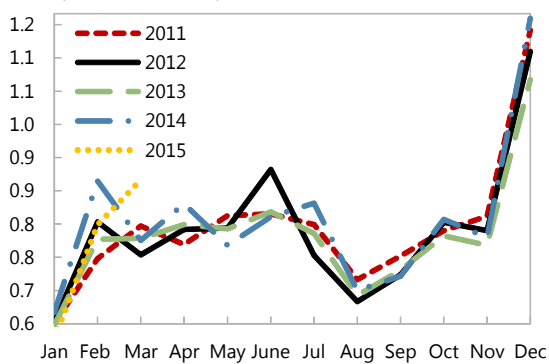
Cumulative Central Government Cash Balance
(Percent of Annual GDP)



Expenditures were under-executed,...

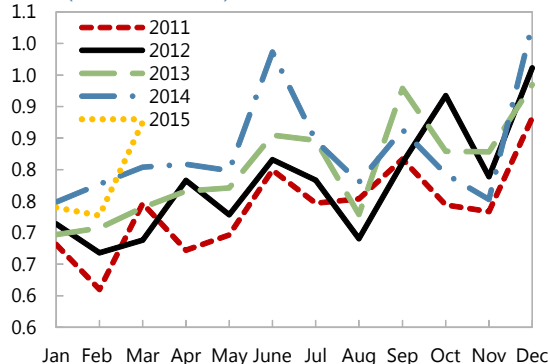
... and revenues overperformed because of better social security contribution collection,...

Total Primary Expenditures
(Billions of Euros)



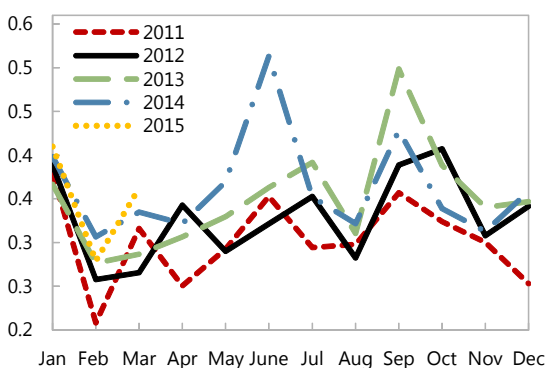
...while taxes performed broadly as planned.

Revenues
(Billions of Euros)



The Social Security (Sodra) deficit, continued to shrink.

Taxes
(Billions of Euros)



Source: Ministry of Finance.

Cumulative Sodra Deficit
(Percent of annual GDP)

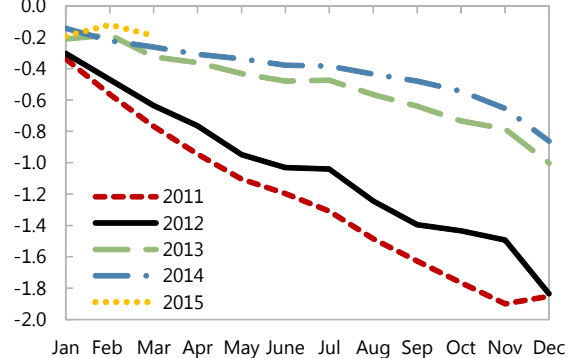


Table 1: Republic of Lithuania: Selected Economic Indicators, 2012–20

Quota (current, % of total): 183.9 million SDR, 0.08 percent
 Main products and exports: mineral, chemical, agricultural
 and wood products, machinery and equipment, textiles
 Key export markets: Russia, Latvia, Estonia, Poland, Germany

Per capita GDP (PPP, 2014): € 20,088
 Literacy rate (2011): 99.7 %
 At-risk-of-poverty (after transfers), share of
 population (2013): 20.6 percent

	2012	2013	2014	2015	2016	2017	2018	2019	2020
	Projections								
Output									
Real GDP growth (annual percentage change)	3.8	3.3	2.9	2.8	3.2	3.4	3.6	3.7	3.7
Domestic demand growth (year-on-year, in percent)	0.1	3.0	4.6	3.8	4.3	4.3	4.4	4.4	4.5
Private consumption growth (year-on-year, in percent)	3.6	4.2	5.6	3.7	4.2	4.0	4.0	3.9	4.0
Domestic fixed investment growth (year-on-year, in percent)	-1.6	7.0	8.0	3.2	5.4	5.5	5.5	6.0	6.1
Inventories (contribution to growth)	-2.1	-1.3	-0.8	0.0	0.0	0.0	0.0	0.0	0.0
Net external demand (contribution to growth)	3.9	0.5	-1.5	-1.0	-1.1	-1.0	-0.9	-0.9	-0.9
Nominal GDP (in billions of euro)	33.3	35.0	36.3	37.7	39.8	42.2	44.8	47.6	50.6
Output gap (percent of potential GDP)	-0.9	-0.3	-0.2	-0.2	-0.1	0.0	0.0	0.0	0.0
Employment									
Unemployment rate (year average, in percent of labor force)	13.4	11.8	10.7	10.6	10.5	10.5	10.5	10.5	10.5
Average monthly gross earnings (annual percentage change)	2.6	5.0	4.5	4.0	3.7	5.6	6.2	6.1	6.2
Average monthly gross earnings, real (CPI-deflated, annual percentage change)	-0.5	3.8	4.3	4.3	1.6	3.4	3.7	3.7	3.9
Labor productivity (annual percentage change)	2.0	1.9	0.9	2.6	3.2	3.4	3.7	3.7	3.9
Prices									
HICP, end of period (year-on-year percentage change)	2.9	0.5	-0.1	0.5	2.0	2.3	2.4	2.3	2.2
GDP deflator (year-on-year percentage change)	2.7	1.6	0.9	0.9	2.5	2.4	2.5	2.5	2.5
HICP core, period average (annual percentage change)	2.0	1.4	0.7	1.3	1.7	2.4	3.0	3.0	3.0
HICP, period average (annual percentage change)	3.2	1.2	0.2	-0.3	2.0	2.2	2.4	2.3	2.3
General government finances 2/									
Revenue (percent of GDP)	33.0	32.8	34.3	33.4	33.0	33.0	33.2	33.3	33.3
Of which EU grants	2.7	2.5	2.8	2.6	2.2	2.1	2.1	2.1	2.1
Expenditure (percent of GDP)	36.1	35.4	34.9	34.8	34.6	34.6	34.7	34.6	34.6
Of which: Non-interest	34.2	33.7	33.4	33.2	33.0	33.0	33.0	33.0	33.0
Interest	1.8	1.7	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Fiscal balance (percent of GDP) 3/	-3.1	-2.6	-0.7	-1.4	-1.6	-1.6	-1.5	-1.4	-1.3
Fiscal balance excl. Deposit Insurance Fund (percent of GDP)	-3.3	-2.2	-2.0	-1.6	-1.6	-1.6	-1.5	-1.4	-1.3
Structural fiscal balance (percent of potential GDP) 4/	-2.5	-1.7	-0.8	-1.2	-1.3	-1.3	-1.3	-1.3	-1.3
General government gross debt (percent of GDP)	39.8	38.8	40.9	38.9	39.0	38.7	38.2	37.6	36.7
Of which: Foreign currency-denominated	31.3	27.1	16.2	13.5	12.7	10.3	9.6	8.9	4.9
Money and credit									
Broad money (end of period, percent change)	7.2	4.4	1.2	..	..	..	..	..	..
Private sector credit (end of period, percent change)	0.3	-3.0	-1.1	1.5	2.0	..	..	..	..
3-month VLIBOR (period average, percent)	1.1	0.5	0.3	..	..	..	..	..	..
Reserve money (end of period, percent change)	-6.4	4.9	20.9	..	..	..	..	..	..
Balance of payments (in percent of GDP, unless otherwise specified)									
Current account balance	-1.2	1.6	0.1	0.5	-0.5	-1.1	-1.4	-1.7	-2.1
Exports of goods and services (volume change, in percent)	12.2	9.4	3.4	1.9	3.4	3.7	3.6	3.4	3.2
Imports of goods and services (volume change, in percent)	6.6	9.0	5.4	3.1	4.8	4.9	4.6	4.4	4.2
Foreign direct investment, net	-0.7	-0.6	-0.5	-0.4	-0.5	-0.7	-0.9	-1.3	-1.3
Gross official reserves (in billions of euros)	6.4	5.9	7.1	..	..	..	..	..	..
Reserve cover (in months of imports of goods and services)	2.9	2.4	2.9	..	..	..	..	..	..
Reserve cover (in percent of short-term debt)	50.4	52.1	57.8	..	..	..	..	..	..
Short-term debt at original maturity	25.3	23.4	21.5	20.0	18.2	16.4	14.7	13.1	11.6
Gross external debt 5/	73.4	67.1	66.7	57.8	53.3	49.0	44.6	40.3	36.1
Exchange rates									
Real effective exchange rate (2005=100, +=appreciation) 5/	117.5	118.7	119.9	..	..	..	..	..	..
Exchange rate (litai per U.S. dollar, end of period)	2.61	2.51	2.84	..	..	..	..	..	..
Exchange rate (litai per U.S. dollar, period average)	2.69	2.60	2.60	..	..	..	..	..	..
Exchange rate (litai per euro, end of period)	3.45	3.45	3.45	..	..	..	..	..	..
Saving-investment balance (in percent of GDP)									
Gross national saving	18.0	20.7	18.8	19.3	19.0	19.1	19.6	20.2	20.7
Gross national investment	19.2	19.1	18.7	18.8	19.5	20.2	21.0	21.9	22.8
Foreign net savings	1.2	-1.6	-0.1	-0.5	0.5	1.1	1.4	1.7	2.1

Sources: Lithuanian authorities; World Bank; Eurostat; and IMF staff estimates and projections.

1/ Data are presented on ESA2010, and BPM6 manuals basis.

2/ The projections for 2014 include 302 million euros (0.8 percent of GDP) in compensation payments for past pension cuts on accrued basis.

The payments are spread over 2014-16, affecting the debt profile for these years. ESM contributions are spread over 2015-19 and also increase debt. Passive projections from 2016 onward; incorporate only announced budgetary measures; budgetary impact of further defense spending, wage compensation and their potential offsetting measures are not included.

3/ Fiscal balance for 2012 according to the definition for purposes of the Excessive Deficit Procedure (EDP).

4/ Calculation takes into account standard cyclical adjustments as well as absorption gap.

5/ Government external debt includes guaranteed loans.

Table 2. Republic of Lithuania: General Government Operations, 2012–20
(ESA 2010 aggregates, in percent of GDP)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
	Projections								
Statement of Operations									
Revenue	33.0	32.8	34.3	33.4	33.0	33.0	33.2	33.3	33.3
Revenue excluding EU grants	30.2	30.3	31.5	30.8	30.8	30.9	31.1	31.1	31.1
Tax revenue	16.0	16.0	16.3	16.2	16.2	16.4	16.5	16.6	16.6
Direct taxes	4.8	4.9	5.0	5.0	5.0	5.0	5.0	5.1	5.1
Personal income tax	3.5	3.6	3.7	3.6	3.5	3.5	3.6	3.6	3.6
Corporate income tax	1.3	1.4	1.4	1.4	1.5	1.5	1.5	1.5	1.5
Indirect taxes	11.2	11.1	11.3	11.2	11.3	11.4	11.5	11.6	11.6
VAT	7.6	7.5	7.6	7.5	7.6	7.7	7.7	7.8	7.8
Excises	2.9	2.8	2.9	2.9	2.9	2.9	3.0	3.0	3.0
Other	0.7	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Social contributions	11.0	11.0	11.4	11.3	11.2	11.2	11.2	11.2	11.2
Grants	2.7	2.5	2.8	2.6	2.2	2.1	2.1	2.1	2.1
Other revenue	3.2	3.4	3.8	3.4	3.4	3.4	3.4	3.4	3.4
Total expenditure	36.1	35.4	34.9	34.8	34.6	34.6	34.7	34.6	34.6
Current spending	32.4	31.8	31.4	31.2	30.9	30.9	31.0	31.0	30.9
Compensation of employees	9.7	9.5	9.5	9.5	9.4	9.4	9.4	9.3	9.3
Goods and services	4.9	4.7	4.8	4.7	4.7	4.7	4.7	4.7	4.7
Interest payments	1.8	1.7	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Foreign	1.6	1.5	1.3	1.2	1.2	1.2	1.1	1.1	1.1
Domestic	0.2	0.3	0.3	0.4	0.4	0.5	0.5	0.5	0.5
Subsidies	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Grants	0.6	0.9	0.9	0.7	0.7	0.7	0.7	0.7	0.7
Social benefits	13.7	12.9	12.5	12.4	12.4	12.4	12.4	12.4	12.4
Other expense	1.3	1.8	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Capital spending	3.7	3.6	3.5	3.6	3.6	3.7	3.7	3.7	3.7
Net lending (+) / borrowing (-)	-3.1	-2.6	-0.7	-1.4	-1.6	-1.6	-1.5	-1.4	-1.3
Net lending (+) / borrowing (-) excl. Dep. Insur. Fund	-3.3	-2.2	-2.0	-1.6	-1.6	-1.6	-1.5	-1.4	-1.3
Net acquisition of financial assets	1.8	-1.2	0.0	0.2	0.2	0.2	0.1	0.1	0.0
Domestic	2.2	-1.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	-0.3	0.5	0.0	0.2	0.2	0.2	0.1	0.1	0.0
Net incurrence of liabilities	5.0	1.4	0.7	1.6	1.7	1.7	1.6	1.5	1.3
Domestic	0.8	2.8	1.1	1.1	1.1	1.1	1.1	1.1	1.0
Foreign	4.2	-1.4	-0.4	0.5	0.7	0.7	0.6	0.4	0.4
Financial Balance Sheet									
Financial assets	24.7	21.9	27.5	..	..	..	..	..	..
Currency and deposits	5.8	3.9	7.5	..	..	..	..	..	..
Securities other than shares	0.0	0.0	0.1	..	..	..	..	..	..
Loans	0.3	0.3	0.3	..	..	..	..	..	..
Shares and other equity	13.5	12.7	14.4	..	..	..	..	..	..
Other financial assets	5.1	5.1	5.2	..	..	..	..	..	..
Financial liabilities	51.1	47.8	52.8	..	..	..	..	..	..
Currency and deposits	0.6	0.7	0.8	..	..	..	..	..	..
Securities other than shares	38.3	34.3	38.5	..	..	..	..	..	..
Loans	7.6	8.1	7.8	..	..	..	..	..	..
Other liabilities	4.6	4.7	5.7	..	..	..	..	..	..
Net financial worth	-26.4	-25.9	-25.4	..	..	..	..	..	..
Memorandum items:									
GDP (in millions of euros)	33,314	34,956	36,288	37,668	39,846	42,178	44,792	47,593	50,607
General government debt (Maastricht def.)	39.8	38.8	40.9	38.9	39.0	38.7	38.2	37.6	36.7
Foreign debt	30.6	27.1	29.6	26.3	25.6	24.9	24.0	23.0	22.0
Domestic debt	9.2	11.6	11.3	12.5	13.4	13.8	14.2	14.6	14.7

Sources: Ministry of Finance; Ministry of Social Security; and IMF staff estimates.

1/ Passive projections from 2016 onward; incorporate only announced budgetary measures; budgetary impact of wage compensation and its potential offsetting measures are not included.

Table 3. Republic of Lithuania: Balance of Payments, 2012–20
(Billions of euro, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections			
Current account balance	-0.4	0.6	0.0	0.2	-0.2	-0.5	-0.6	-0.8	-1.0
Merchandise trade balance	-1.1	-0.9	-1.5	-1.6	-2.0	-2.4	-2.9	-3.5	-4.1
Exports (f.o.b.)	22.4	24.0	23.8	24.4	26.1	27.7	29.3	30.9	32.4
Imports (f.o.b.)	23.5	24.9	25.3	26.0	28.1	30.1	32.2	34.4	36.5
Services balance	1.4	1.4	1.6	1.7	1.7	1.8	2.2	2.5	2.9
Exports of non-factor services	4.8	5.4	5.9	6.1	7.0	8.1	9.6	11.2	12.9
Imports of non-factor services	3.4	4.0	4.3	4.4	5.3	6.3	7.4	8.7	10.0
Primary income balance	-1.1	-0.9	-1.1	-1.1	-1.0	-1.0	-1.0	-1.1	-1.1
Receipts	0.9	0.9	0.7	0.7	0.8	0.8	0.9	0.9	1.0
Payments	2.0	1.8	1.8	1.8	1.8	1.8	1.9	2.0	2.1
Secondary income balance	0.4	1.0	1.1	1.2	1.1	1.1	1.2	1.2	1.2
Capital and financial account balance	0.7	-0.7	2.0	-0.3	0.7	0.9	0.9	1.1	1.0
Capital transfer balance	1.0	1.0	1.0	1.0	0.6	0.8	0.8	0.9	0.9
Foreign direct investment balance	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3	-0.4	-0.7	-0.7
Portfolio investment balance	-0.9	1.4	-1.2	0.9	0.1	0.1	0.1	0.2	0.2
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment balance	1.5	0.6	0.4	0.5	0.1	0.2	0.3	0.3	0.4
Errors and omissions	-0.2	-0.3	-0.8	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	0.1	-0.4	1.3	-0.1	0.5	0.4	0.2	0.3	0.0
Financing	-0.1	0.4	-1.3	0.1	-0.5	-0.4	-0.2	-0.3	0.0
Gross international reserves (increase: -)	-0.1	0.4	-1.3	...	...	...	...	...	...
Use of Fund credit, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Prospective Financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
In percent of GDP (unless indicated)									
Current account balance	-1.2	1.6	0.1	0.5	-0.5	-1.1	-1.4	-1.7	-2.1
Trade Balance of goods and services	0.9	1.3	0.1	0.2	-0.7	-1.4	-1.7	-2.0	-2.3
Exports	81.7	84.1	81.8	81.0	83.0	84.8	86.8	88.5	89.6
Imports	80.8	82.8	81.7	80.8	83.7	86.2	88.5	90.5	91.8
Primary Income	-3.2	-2.5	-3.1	-2.9	-2.5	-2.4	-2.3	-2.2	-2.2
Secondary Income	1.2	2.8	3.1	3.1	2.7	2.7	2.6	2.5	2.4
Capital and financial account balance	2.0	-2.0	5.5	-0.7	1.7	2.0	1.9	2.3	2.0
Capital transfers	3.0	3.0	2.7	2.8	1.6	2.0	1.9	2.0	1.9
Foreign direct investment balance	-0.7	-0.6	-0.5	-0.5	-0.6	-0.7	-1.0	-1.4	-1.4
Portfolio investment balance	-2.8	4.0	-3.2	2.5	0.2	0.2	0.3	0.4	0.5
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment balance	4.5	1.6	1.0	1.4	0.3	0.4	0.6	0.7	0.7
Overall balance	0.4	-1.2	3.5	-0.2	1.2	0.9	0.5	0.6	0.0
Gross external debt 1/	73.4	67.1	66.7	57.8	53.3	49.0	44.6	40.3	36.1
Public	34.0	30.4	35.0	31.0	30.1	29.2	28.1	26.9	25.7
Short-term	2.9	2.9	3.0	2.6	2.6	2.5	2.5	2.4	2.3
Long-term	31.1	27.6	32.0	28.4	27.6	26.7	25.6	24.5	23.4
Private	39.4	36.6	31.7	26.7	23.2	19.8	16.5	13.4	10.4
Short-term	27.8	26.8	22.6	18.4	15.6	13.0	10.5	8.2	5.9
Long-term	11.6	9.9	9.1	8.4	7.5	6.8	6.0	5.2	4.5
Gross external debt (in percent of GNFS exports)	89.8	79.8	81.5	71.3	64.2	57.7	51.3	45.5	40.4
Net external Debt	33.6	28.7	29.2	22.0	18.5	15.1	11.9	8.5	5.8
Net international investment position	-53.0	-46.5	-44.2	-39.4	-36.4	-33.7	-31.5	-29.5	-28.1
GIR (in billions of Euros)	6.4	5.9	7.1	...	...	...	...	...	...
GIR (in percent of short-term debt) 2/	50.4	52.1	57.8	...	...	...	...	...	...
GIR (in months of imports of goods and services)	2.9	2.4	2.9	...	...	...	...	...	...
Merchandise export volume (percent change) 3/	12.2	9.4	3.4	1.9	3.4	3.7	3.6	3.4	3.2
Merchandise import volume (percent change) 3/	6.6	9.0	5.4	3.1	4.8	4.9	4.6	4.4	4.2
Merchandise export prices (percent change) 3/	3.4	-1.3	-2.4	0.8	3.2	2.3	2.1	2.1	1.5
Merchandise import prices (percent change) 3/	4.2	-1.4	-3.1	-0.3	3.0	2.3	2.3	2.3	1.8
GDP (in billion of Euros)	33.3	35.0	36.3	37.7	39.8	42.2	44.8	47.6	50.6

Sources: Data provided by the Lithuanian authorities; IMF International Financial and Trade Statistics; and IMF staff estimates and projections.

1/ Government external debt does not include guaranteed loans.

2/ Short-term debt at remaining maturity.

3/ Derived from national accounts data.

Table 4. Republic of Lithuania: Summary of Monetary Accounts, 2009–14
(Billions of euro, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014
Monetary Authority						
Gross foreign assets	4.6	5.2	6.4	6.4	6.0	7.9
Gross foreign liabilities	0.1	0.2	0.3	0.0	0.0	0.1
Net foreign assets	4.5	5.0	6.1	6.4	6.0	7.8
Gold	0.1	0.2	0.2	0.2	..	..
Net domestic assets	-1.4	-1.4	-1.1	-1.7	-1.0	-1.9
Net credit to government	-0.8	-0.7	-0.4	-1.1	-0.5	-1.2
Credit to banks	0.0	0.0	0.0	0.0	0.0	0.0
Credit to private sector	0.0	0.0	0.0	0.0	0.0	0.0
Other items, net	-0.7	-0.6	-0.7	-0.7	-0.6	-0.7
Reserve money	3.0	3.6	5.0	4.7	4.9	5.9
Currency outside the central bank	2.3	2.6	3.1	3.3	3.4	1.7
Currency outside banks	2.0	2.3	2.8	3.0	3.2	1.4
Cash in vaults of banks	0.3	0.3	0.3	0.3	0.3	0.3
Deposit money banks' deposits with BoL	0.8	1.1	1.9	1.4	1.5	4.3
Banking Survey						
Net foreign assets	-1.6	0.4	1.6	2.8	2.9	4.5
Monetary authority	4.5	5.0	6.1	6.4	6.0	7.8
Banks and other banking institutions	-6.1	-4.6	-4.5	-3.6	-3.1	-3.3
Net domestic assets	14.4	13.5	13.1	12.9	13.5	12.1
Net claims on government 1/	-0.7	0.2	-0.3	0.1	1.1	0.3
Monetary authority	-0.8	-0.7	-0.4	-1.1	-0.5	-1.2
Banks and other banking institutions	0.0	0.9	0.1	1.2	1.6	1.5
Credit to private sector	17.8	16.4	15.5	15.5	15.1	14.9
Credit to nonbank financial institutions	0.8	1.1	1.0	1.3	0.9	0.9
Other items, net	-3.4	-4.2	-3.1	-4.0	-3.7	-4.0
Broad money	12.8	13.9	14.6	15.7	16.4	16.6
Currency outside banks	2.0	2.3	2.8	3.0	3.2	1.4
Deposits	10.6	11.6	11.7	12.5	13.1	15.2
In national currency	7.2	8.3	8.6	9.2	9.6	11.2
In foreign currency	3.4	3.3	3.1	3.4	3.5	4.0
Memorandum items:						
Reserve money (yearly percent change)	-17.2	19.4	37.5	-6.4	4.9	20.9
Broad money (yearly percent change)	0.3	8.9	5.0	7.2	4.4	1.2
Private sector credit (yearly percent change)	-6.9	-7.6	-5.7	0.3	-3.0	-1.1
Money multiplier	4.2	3.8	2.9	3.3	3.3	2.8
Currency outside banks, in percent of deposits	19.0	19.7	24.1	23.8	24.2	8.9
Foreign-currency deposits (percent of total deposits)	32.0	28.6	26.8	26.7	26.7	26.1
Foreign-currency loans (percent of total loans) 2/	73.5	74.6	74.3	72.8	72.1	72.8
Velocity of broad money	2.1	2.0	2.1	2.1	2.1	2.2
Gross official reserves (billions of U.S. dollars) 3/	6.7	6.6	8.4	8.4	8.0	8.8
Gross official reserves (billions of euros) 3/	4.6	5.0	6.3	6.4	5.9	7.2
Excess reserve coverage 4/	14.5	13.1	12.0	13.7	8.1	12.9
GDP	26.9	28.0	31.2	33.3	35.0	36.3

Sources: Bank of Lithuania; and IMF staff estimates and projections.

1/ Excludes local government deposits; includes counterpart funds.

2/ Loans to households and non-financial corporations.

3/ BOP basis. Differs from gross foreign assets as shown in the monetary authority's balance sheet because of valuation effects (BoP-basis official reserves include accrued interest on deposits and securities but exclude investments in shares and other equity).

4/ Bank of Lithuania's gross foreign assets less reserve money, in percent of banking system deposits.

Table 5. Republic of Lithuania: Financial Soundness Indicators, Banking System Data, 2007–14
(Percent, unless otherwise indicated)

	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14
Capital adequacy								
Regulatory capital to risk-weighted assets 1/ 9/	10.9	11.6	12.9	14.8	14.2	15.7	17.6	21.3
Regulatory Tier 1 capital to risk-weighted assets 1/ 9/	7.7	9.1	9.3	10.8	12.0	14.6	17.1	20.9
Capital to assets 1/	7.9	8.9	9.4	10.9	10.2	11.4	12.6	13.4
Asset quality								
Nonperforming loans to capital 1/ 4/	..	41.8	198.8	174.7	109.8	79.4	59.6	42.2
o/w impaired loans to capital 1/ 4/	..	30.3	161.2	143.7	92.8	65.7	44.4	34.2
o/w non-impaired loans overdue more than 60 days to capital 1/ 4/	..	11.5	37.6	30.9	17.0	13.7	15.2	8.0
Nonperforming loans net of provisions to capital 1/ 4/ 13/	..	31.0	133.1	106.0	63.5	46.9	36.7	27.0
Nonperforming loans to total (non-interbank) loans 4/	..	4.7	19.7	19.9	16.6	13.6	11.0	6.5
o/w impaired loans to total (non-interbank) loans 4/	..	3.4	15.7	16.7	14.0	11.4	8.5	5.3
o/w non-impaired loans overdue more than 60 days to total (non-interbank) loans 4/	..	1.3	3.9	3.3	2.5	2.2	2.5	1.2
Impairment losses to total (non-interbank) loans 12/ 13/	0.7	1.3	6.7	8.0	7.0	5.6	4.2	3.4
Impairment losses to nonperforming loans 3/ 4/ 12/ 13/	72.2	26.8	33.9	40.2	42.2	40.8	37.9	36.0
Sectoral distribution of corporate loans 6/								
Agriculture, hunting, forestry	1.7	2.1	1.9	1.9	2.4	2.3	2.8	2.9
Water supply; sewerage, waste management and remediation activities	0.0	0.0	0.0	0.0	0.7	0.7	0.8	1.0
Mining and quarrying	0.1	0.2	0.2	0.3	0.4	0.6	0.5	0.5
Manufacturing	9.9	10.7	10.3	9.4	17.4	18.3	18.0	15.6
Electricity, gas, steam and air conditioning supply	2.2	1.9	1.9	2.1	5.0	6.8	7.6	9.5
Construction	4.1	3.8	3.1	2.9	12.8	10.3	8.6	7.2
Wholesale and retail trade	10.7	10.7	9.7	8.8	19.3	19.7	19.3	20.3
Hotels and restaurants	1.4	1.6	1.7	1.5	2.8	2.8	2.8	2.6
Transport, storage and communication	2.2	2.5	2.6	2.3	4.3	4.0	5.7	5.4
Real estate, renting and other business activities	16.8	18.4	20.2	19.1	28.9	27.8	28.3	27.7
Other types of economic activities	0.0	0.0	0.0	0.0	1.2	1.1	1.2	1.1
Information and communication	..	..	..	..	0.9	0.8	0.8	0.9
Professional, scientific and technical activities	..	..	..	..	2.8	4.0	2.6	3.5
Administrative and support service activities	..	..	..	..	1.1	0.9	1.0	1.9
Residential real estate loans to total (non-interbank) loans	27.8	29.6	33.0	34.3	36.7	37.9	38.0	38.9
Large exposures to regulatory capital 1/ 5/	152.7	129.4	114.9	..	..	..	..	..
Earnings and profitability								
RoE 1/ 2/	25.9	11.8	-50.8	-3.9	15.8	7.7	8.9	8.1
RoA 2/	1.7	0.8	-3.8	-0.3	1.4	0.9	1.0	0.9
Interest margin to gross income	55.8	64.4	50.6	49.0	58.7	53.7	49.9	50.7
Noninterest expenses to gross income	49.8	54.6	60.3	64.4	60.2	61.9	61.9	35.0
Trading and foreign exchange gains (losses) to gross income	8.1	0.9	13.5	8.1	4.0	9.1	8.8	8.6
Personnel expenses to noninterest expenses	43.6	41.8	38.7	37.5	40.6	39.5	39.0	67.4
Liquidity								
Liquidity ratio (liquid assets to current liabilities) 7/	43.5	39.0	49.9	43.8	44.1	41.2	41.2	43.6
Liquid assets to total assets 7/	21.9	18.6	23.7	23.8	23.7	25.1	27.0	31.9
Current liabilities to total liabilities 7/	54.2	51.4	50.5	58.5	58.8	67.7	73.1	81.6
3-month VILIBOR-EURIBOR spread, b.p. 8/	229.6	699.8	320.0	49.4	30.4	49.0	12.0	10.0
Spread between highest and lowest interbank rate, b.p. 10/	690.0	1650.0	970.0	436.0	218.0	34.0	39.0	25.0
Customer deposits to total non-interbank loans	66.4	56.8	68.6	82.2	80.6	85.8	93.3	110.4
Foreign exchange risk								
Foreign-currency-denominated loans to total (non-interbank) loans 11/	55.6	64.6	73.9	74.0	72.4	72.4	68.7	..
Foreign-currency-denominated liabilities to total liabilities 11/	56.2	63.3	61.6	57.0	53.1	50.9	48.1	..
Net open position in foreign exchange to regulatory capital 1/ 9/	-2.4	1.0	1.0	0.5	0.6	0.3	0.4	..
Memo item								
Provisioning (in percent of NPLs)	..	25.9	33.0	39.3	42.2	41.0	38.4	36.0

Sources: Bank of Lithuania & <http://fsi.imf.org/>

1/ Excluding foreign bank branches.

2/ Total profits (losses) after tax. Interim quarterly results are annualised.

3/ From end-2005 to Q1-2008, NPLs are loans overdue more than 60 days. Until 2004 NPLs are loans in Substandard, Doubtful and Loss loans categories.

4/ Starting June 2008, non-performing loans are defined as the sum of impaired loans and non-impaired loans that are overdue more than 60 days.

5/ Large exposure means loans granted to the borrower the net value of which equals to, or exceeds, 10 per cent of bank capital.

6/ Credit registry data from 2005. According to Nace 1 up to Sept 2011. Data according to Nace 2 thereafter.

7/ Composition of liquid assets and current liabilities is defined in the Liquidity Ratio Calculation Rules approved by Resolution No. 1 of the Board of the Bank of Lithuania of 29 January 2004.

8/ Data as of the end of period.

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

10/ Information is based on interbank deals of all maturities (mostly overnights) made between resident banks in national currency within the last quarter of the period.

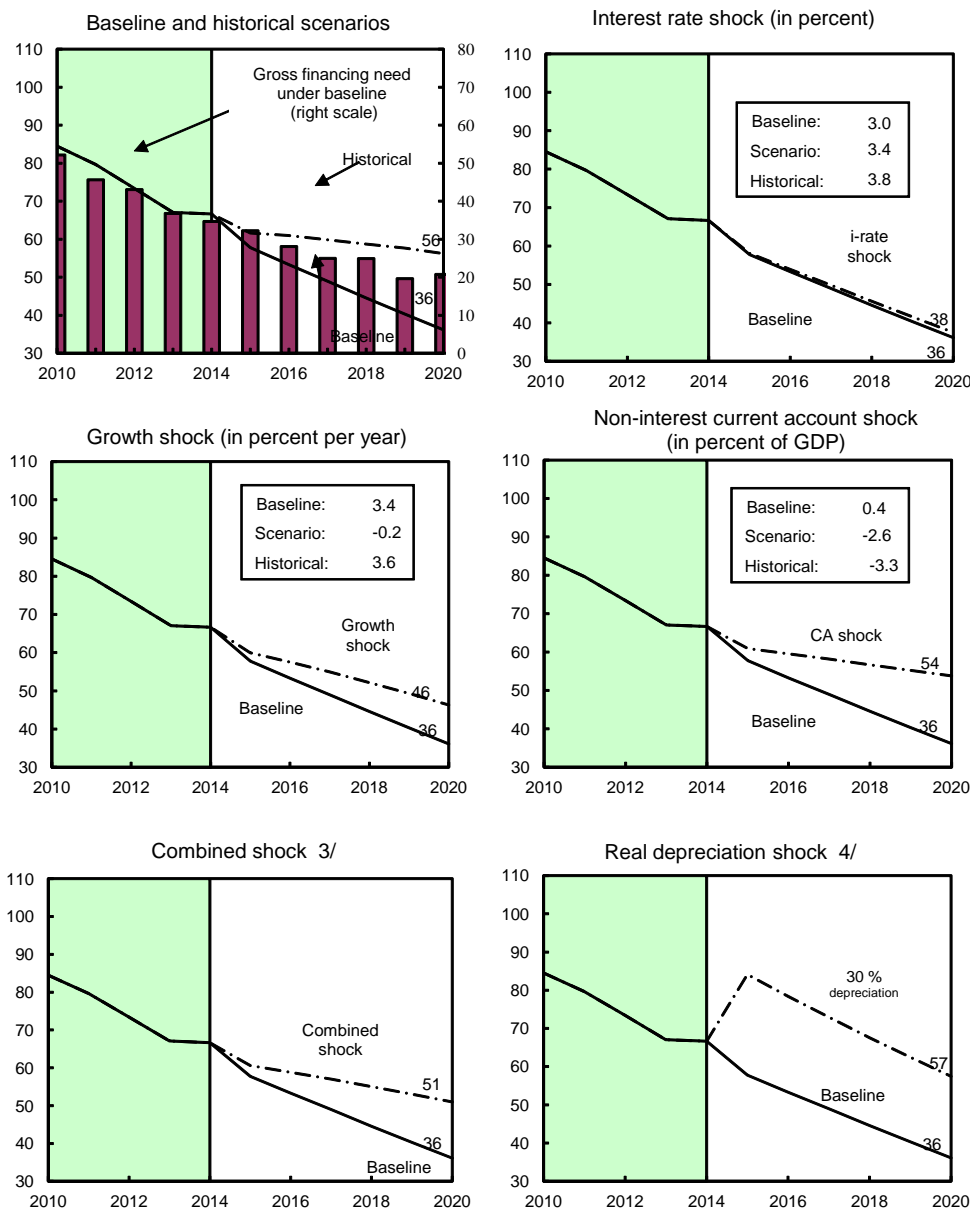
11/ The large majority of foreign currency loans and foreign currency liabilities are in euros, to which the national currency is pegged via a currency board arrangement.

12/ Specific provisions include provisions against general portfolio risk until end-2004. From end-2005, due to the change in definition of NPLs, specific provisions are not directly attributable to the NPLs. Therefore, the ratio may be negative.

13/ Specific provisions include allowances for both individually and collectively assessed loans.

Annex I. Debt Sustainability Analysis (DSA)

Figure A1. Republic of Lithuania: External Debt Sustainability Analysis: Bound Tests ^{1/ 2/}
(External debt in percent of GDP)



Sources: International Monetary Fund, Lithuanian authorities, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2015.

Table A1. Republic of Lithuania: External Debt Sustainability Framework, 2009–20

(In percent of GDP, unless otherwise indicated)

	Actual					Projections							Debt-stabilizing non-interest current account 6/ -3.7
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	
Baseline: External debt	86.9	84.5	79.6	73.4	67.1	66.7	57.8	53.3	49.0	44.6	40.3	36.1	
Change in external debt	12.9	-2.4	-4.9	-6.2	-6.3	-0.4	-8.9	-4.5	-4.3	-4.4	-4.3	-4.2	
Identified external debt-creating flows (4+8+9)	14.0	-3.7	-7.9	-3.9	-5.4	-1.8	-3.8	-2.9	-2.5	-2.5	-2.4	-2.0	
Current account deficit, excluding interest payments	-5.0	-2.3	1.2	-1.4	-3.8	-2.1	-2.3	-1.0	-0.3	0.1	0.4	0.8	
Deficit in balance of goods and services	1.7	1.9	2.6	-0.9	-1.3	-0.1	-0.2	0.7	1.4	1.7	2.0	2.3	
Exports	51.9	65.4	75.1	81.7	84.1	81.8	81.0	83.0	84.8	86.8	88.5	89.6	
Imports	53.6	67.3	77.6	80.8	82.8	81.7	80.8	83.7	86.2	88.5	90.5	91.8	
Net non-debt creating capital inflows (negative)	0.3	-0.8	-3.0	-0.1	-0.4	0.2	-1.6	-1.7	-1.9	-2.3	-2.6	-2.6	
Automatic debt dynamics 1/	18.7	-0.6	-6.1	-2.3	-1.3	0.1	0.0	-0.2	-0.3	-0.3	-0.3	-0.2	
Contribution from nominal interest rate	2.9	2.7	2.7	2.6	2.2	2.0	1.8	1.5	1.4	1.4	1.3	1.2	
Contribution from real GDP growth	13.3	-1.4	-4.6	-2.9	-2.3	-1.9	-1.8	-1.8	-1.7	-1.6	-1.5	-1.4	
Contribution from price and exchange rate changes 2/	2.5	-2.0	-4.1	-2.1	-1.2	...	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	-1.1	1.3	3.0	-2.4	-0.9	1.4	-5.0	-1.6	-1.8	-1.9	-1.8	-2.2	
External debt-to-exports ratio (in percent)	167.4	129.2	106.1	89.8	79.8	81.5	71.3	64.2	57.7	51.3	45.5	40.4	
Gross external financing need (in billions of Euro) 4/	15.5	14.6	14.3	14.3	12.9	12.6	12.1	11.2	10.5	11.2	9.3	10.5	
in percent of GDP	57.5	52.2	45.7	43.0	36.8	34.7	32.2	28.1	24.9	24.9	19.6	20.8	
Scenario with key variables at their historical averages 5/						66.7	61.6	60.9	59.9	58.8	57.7	56.2	-3.7
Key Macroeconomic Assumptions Underlying Baseline													
Real GDP growth (in percent)	-14.8	1.6	6.1	3.8	3.3	2.9	2.8	3.2	3.4	3.6	3.7	3.7	
GDP deflator in Euro (change in percent)	-3.3	2.3	5.2	2.7	1.6	0.9	0.9	2.5	2.4	2.5	2.5	2.5	
Nominal external interest rate (in percent)	3.2	3.2	3.5	3.5	3.1	3.1	2.9	2.8	2.8	2.9	3.0	3.3	
Growth of exports (Euro terms, in percent)	-25.1	30.9	28.1	16.1	8.0	1.0	2.8	8.3	8.2	8.7	8.4	7.5	
Growth of imports (Euro terms, in percent)	-35.7	30.5	28.7	11.1	7.5	2.4	2.7	9.6	9.1	9.0	8.7	7.8	
Current account balance, excluding interest payments	5.0	2.3	-1.2	1.4	3.8	2.1	2.3	1.0	0.3	-0.1	-0.4	-0.8	
Net non-debt creating capital inflows	-0.3	0.8	3.0	0.1	0.4	-0.2	1.6	1.7	1.9	2.3	2.6	2.6	

1/ Derived as $[r - g - r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock. r increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

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

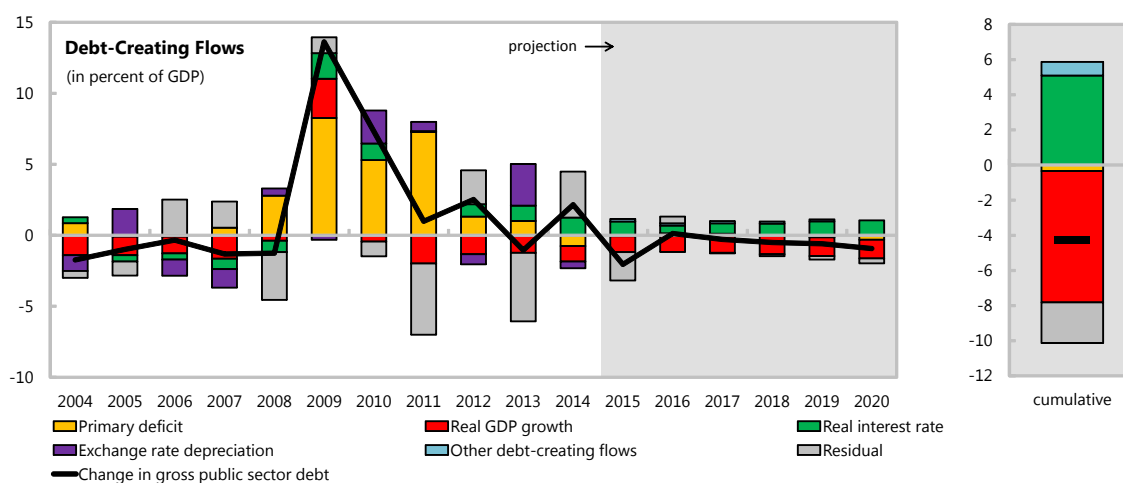
Figure A2. Public Debt Sustainability Analysis: Baseline

(In percent of GDP unless otherwise indicated)

	Debt, Economic and Market Indicators ^{1/}										As of May 06, 2015		
	Actual			Projections									
	2004-2012 ^{2/}	2013	2014	2015	2016	2017	2018	2019	2020				
Nominal gross public debt	25.1	38.8	40.9	38.9	39.0	38.7	38.2	37.6	36.7		Sovereign Spreads		
											EMBIG (bp) ^{3/}	38	
Public gross financing needs	8.2	8.0	3.5	8.3	5.1	4.2	6.3	3.2	7.0		5Y CDS (bp)	90	
Real GDP growth (in percent)	3.7	3.3	2.9	2.8	3.2	3.4	3.6	3.7	3.7	Ratings	Foreign	Local	
Inflation (GDP deflator, in percent)	4.6	1.6	0.9	0.9	2.5	2.4	2.5	2.5	2.5	Moody's	Baa1	Baa1	
Nominal GDP growth (in percent)	8.6	4.9	3.8	3.8	5.8	5.9	6.2	6.3	6.3	S&Ps	A-	A-	
Effective interest rate (in percent) ^{4/}	5.3	4.5	4.2	3.4	4.0	4.5	4.9	5.3	5.6	Fitch	A-	A-	

Contribution to Changes in Public Debt

	Actual			Projections							cumulative	debt-stabilizing primary balance ^{9/}
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020			
Change in gross public sector debt	2.1	-1.1	2.2	-2.1	0.1	-0.3	-0.5	-0.6	-0.9	-4.3		
Identified debt-creating flows	2.4	3.8	-1.1	-0.1	-0.3	-0.2	-0.4	-0.4	-0.6	-2.0		
Primary deficit	2.9	1.0	-0.8	-0.1	0.1	0.1	0.0	-0.1	-0.3	-0.3		
Primary (noninterest) revenue and grants	33.9	32.7	34.1	33.3	32.8	32.9	33.1	33.2	33.3	198.5		
Primary (noninterest) expenditure	36.8	33.7	33.4	33.2	33.0	33.0	33.0	33.0	33.0	198.2		
Automatic debt dynamics ^{5/}	-0.5	2.8	-0.3	-0.2	-0.6	-0.5	-0.5	-0.3	-0.3	-2.4		
Interest rate/growth differential ^{6/}	-0.6	-0.2	0.2	-0.2	-0.6	-0.5	-0.5	-0.3	-0.3	-2.4		
Of which: real interest rate	0.2	1.1	1.2	1.0	0.5	0.7	0.8	1.0	1.0	5.1		
Of which: real GDP growth	-0.8	-1.2	-1.1	-1.1	-1.2	-1.2	-1.3	-1.3	-1.3	-7.5		
Exchange rate depreciation ^{7/}	0.1	2.9	-0.5	...	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.2	0.2	0.2	0.1	0.1	0.0	0.8		
Please specify (1) (e.g., drawdown of deposits)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Please specify (2) (e.g., ESM and Euroarea)	0.0	0.0	0.0	0.2	0.2	0.2	0.1	0.1	0.0	0.8		
Residual, including asset changes ^{8/}	-0.3	-4.8	3.2	-2.0	0.5	0.0	-0.1	-0.3	-0.3	-2.3		



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

 5/ Derived as $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+g\pi)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

 6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

 7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

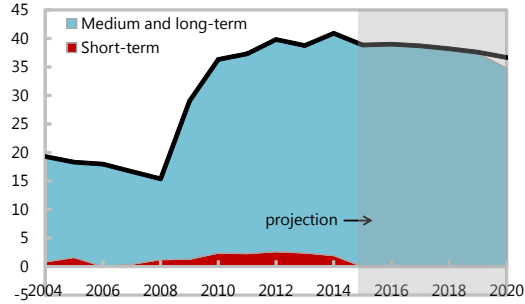
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table A2. Republic of Lithuania: Public Debt Sustainability
(Composition of Public Debt and Alternative Scenarios)

Composition of Public Debt

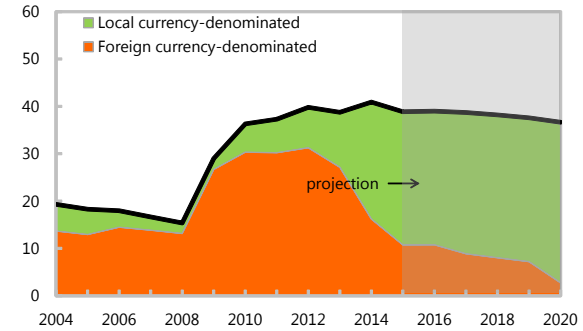
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

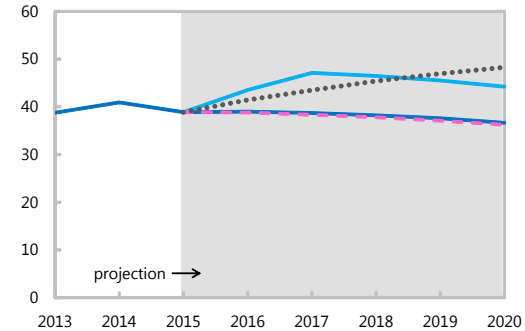


Alternative Scenarios

— Baseline
— Contingent Liability Shock
..... Historical
— Constant Primary Balance

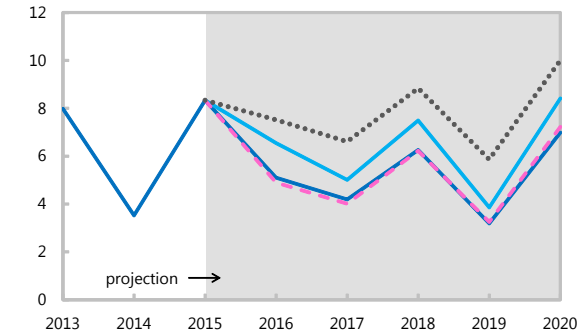
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions
(in percent)

	2015	2016	2017	2018	2019	2020
Baseline Scenario						
Real GDP growth	2.8	3.2	3.4	3.6	3.7	3.7
Inflation	0.9	2.5	2.4	2.5	2.5	2.5
Primary Balance	0.1	-0.1	-0.1	0.0	0.1	0.3
Effective interest rate	3.4	4.0	4.5	4.9	5.3	5.6
Constant Primary Balance Scenario						
Real GDP growth	2.8	3.2	3.4	3.6	3.7	3.7
Inflation	0.9	2.5	2.4	2.5	2.5	2.5
Primary Balance	0.1	0.1	0.1	0.1	0.1	0.1
Effective interest rate	3.4	4.0	4.5	4.9	5.3	5.6

	2015	2016	2017	2018	2019	2020
Historical Scenario						
Real GDP growth	2.8	3.2	3.2	3.2	3.2	3.2
Inflation	0.9	2.5	2.4	2.5	2.5	2.5
Primary Balance	0.1	-2.5	-2.5	-2.5	-2.5	-2.5
Effective interest rate	3.4	4.0	4.1	4.2	4.3	4.3
Contingent Liability Shock						
Real GDP growth	2.8	-3.8	-3.6	3.6	3.7	3.7
Inflation	0.9	0.7	0.7	2.5	2.5	2.5
Primary Balance	0.1	-0.9	-0.1	0.0	0.1	0.3
Effective interest rate	3.4	4.6	4.5	4.9	5.3	5.5

Source: IMF staff.



REPUBLIC OF LITHUANIA

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

May 11, 2015

Prepared By

European Department

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FUND RELATIONS

(As of March 31, 2015)

Membership Status: Joined: April 29, 1992; Article VIII

General Resources Account:

	SDR Million	Percent of Quota
Quota	183.90	100.00
Fund holdings of currency (Exchange Rate)	183.88	99.99
Reserve Tranche Position	0.03	0.02

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	137.24	100.00
Holdings	137.31	100.05

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Aug 30, 2001	Mar 29, 2003	86.52	0.00
Stand-By	Mar 08, 2000	Jun 07, 2001	61.80	0.00
Stand-By	Oct 24, 1994	Oct 23, 1997	134.55	134.55

Projected Payments to Fund:

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2014	2015	2016	2017	2018
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

Implementation of HIPC Initiative: Not applicable.

Implementation of MDRI Assistance: Not applicable.

Implementation of Post-Catastrophe Debt Relief (PCDR): Not applicable.

Exchange Rate Arrangement:

As of January 1, 2015, the currency of Lithuania is the euro, which floats freely and independently against other currencies. Prior to 2015, the currency of Lithuania was the litas. From April 1, 1994 to February 1, 2002, the litas was pegged to the U.S. dollar at LTL 4 per U.S. dollar under a currency board arrangement. From February 2, 2002 to Dec 31, 2014, the litas was pegged to the euro at LTL 3.4528 per euro. Lithuania joined the European Union (EU) on May 1, 2004, and ERM II on June 28, 2004. Lithuania has accepted the obligations of Article VIII of the Fund's Articles of Agreement and maintains an exchange system free of restrictions on the making of payment and transfers for current international transactions except for those maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

Previous Article IV Consultation:

Lithuania is on the 12-month consultation cycle. The last Article IV consultation was concluded on May 5, 2014. The Executive Board assessment is available at <https://www.imf.org/external/np/sec/pr/2014/pr14206.htm> and the staff report and other mission documents at <https://www.imf.org/external/pubs/cat/longres.aspx?sk=41537.0>.

Safeguards Assessment:

Under the Fund's safeguards assessment policy, the Bank of Lithuania (BOL) was subject to and completed a safeguards assessment with respect to the Stand-By Arrangement, (the SBA was approved on August 30, 2001 and expired on March 29, 2003) on December 10, 2001. The assessment identified certain weaknesses and proposed appropriate recommendations as reported in EBS/01/211. The BOL has implemented these recommendations.

FSAP Participation and ROSCs:

An FSAP Update mission was completed on November 19, 2007. Fiscal and statistics ROSCs were completed in November 2002 and December 2002, respectively.

Republic of Lithuania: Technical Assistance from the Fund, 1999–2014

Department	Issue	Action	Date	Counterpart
STA	Balance of payments statistics (also covering Latvia)	Mr. Buxton	Resident Advisor, Oct. 1999–Oct. 2000	Bank of Lithuania
LEG	Bankruptcy legislation	Mr. Dimitrachkov	Mar. 2000	Ministry of Economy
FAD	Establishment of Fiscal Reserve Fund	Mission	Jul. 2000	State Privatization Fund
MAE	Multi-topic	Mission	Mar. 2001	Bank of Lithuania
FAD	Tax policy issues	Mission	Jun. 13–26, 2001	Ministry of Finance
STA	ROSC	Mission	May 8–22, 2002	Department of Statistics, Ministry of Finance, and Bank of Lithuania
FAD	ROSC	Mission	Jul. 10–23, 2002	Ministry of Finance
FAD	Treasury Operations	Mr. Ramachandran	Nov. 22–Dec. 5, 2004	Ministry of Finance
FAD	Decentralization	Mission	Dec. 3–Dec. 15, 2004	Ministry of Finance
STA	External debt statistics	Mission	Aug. 2–4, 2006	Bank of Lithuania
MCM	Stress testing	Mr. Miguel A. Segoviano Basurto	Jun. 11–21, 2007	Bank of Lithuania
STA	External debt statistics	Mission	Nov. 8–19, 2007	Bank of Lithuania
FAD	Public expenditure review	WB mission / Ms. Budina (FAD) participation	Apr. 14–24, 2009	Ministry of Finance
FAD	Tax Administration	Mission	Aug. 26–Sep. 8, 2009	Ministry of Finance
MCM/LEG	Bank Resolution/Banking Law	Mission	Sep. 28–Oct. 6, 2009	Bank of Lithuania/Ministry of Finance
FAD	Reform of Social Security and Health Funds	Mission	Apr. 6–20, 2010	Ministry of Finance/State Social Insurance Fund Board
LEG	Personal Bankruptcy Reform	Mission	Apr. 30–May 8, 2010	Ministry of Economy
FAD	Tax Administration	Mission	Jul. 14–27, 2010	Ministry of Finance
FAD	General Tax Policy	Mission	Oct. 19–25, 2010	Ministry of Finance
STA	GFS 2001 Statistics	Mission	Feb. 11–22, 2013	Ministry of Finance
MCM	Credit Unions	Mission	Nov. 18–29, 2013	Bank of Lithuania
MCM	Stress Testing	Mission	Dec. 16–18, 2013	Bank of Lithuania
FAD	Local Government Finance	Mission	Dec. 9–16, 2014	Ministry of Finance

Resident Representative:

James Roaf (stationed in Warsaw, Poland).

Anti-Money Laundering (AML) and Combating Financing of Terrorism (CFT): Lithuania's compliance with the Financial Action Task Force (FATF) standard, was last assessed by MONEYVAL, the FATF-style regional body of which it is a member, in April 2012. The assessment report was published in December 2012. Lithuania was rated partially compliant on nineteen FATF Recommendations, leading to the application of the first stage of the Compliance Enhancing Procedure (CEP) to Lithuania. In response, the authorities amended the Criminal Code and the AML/CFT Law and put in place secondary legislation and guidelines. This extended the list of punishable activities, criminalized financing of terrorism, reorganized the suspicious transactions reporting system, strengthened customer due diligence, and extended record keeping requirements. Lithuania has submitted to date three compliance reports under the CEP procedure. In recognition of the progress achieved in the key areas of concern, MONEYVAL ended the CEP in April 2015, but recommended that the authorities address the remaining deficiencies and ensure effective implementation of its AML/CFT framework in order to exit the regular follow-up procedures. Lithuania is scheduled to undergo the next round of mutual evaluation under the revised FATF methodology in the first quarter of 2017.

STATISTICAL ISSUES

General: Over the past several years, Lithuania has made good progress in establishing a macroeconomic database. Official data for all sectors are adequate for surveillance purposes. Lithuania subscribed to the Special Data Dissemination Standard (SDDS) in May 1996, and its metadata have been posted on the Fund's Dissemination Standards Bulletin Board (DSBB) since April 1997. Lithuania meets the SDDS specifications for coverage, periodicity and timeliness of the data, and for the dissemination of the advance release calendars. A significant amount of economic and financial information is now available on various websites through the Internet (see section on Dissemination of Statistics, below). A ROSC data module was published in November 2002. Data provision to the Fund for surveillance purposes is considered adequate.

National Accounts: The national accounts are compiled by Statistics Lithuania (SL) in accordance with the guidelines of the European System of Accounts 2010 (ESA 2010) from 2005 data onwards (data before 2005 still follow the European System of Accounts 1995, ESA 95). Quarterly GDP estimates at current and at constant prices are compiled using the production, expenditure and income approaches. GDP estimates by production are considered to be more reliable than the corresponding estimates by expenditure and income, but no statistical discrepancies between these three estimates are shown separately in the published figures as the discrepancies are included in the estimates of changes in inventories (expenditure approach) and operating surplus and mixed income (income approach). The annual and the quarterly national accounts are compiled at previous year prices and chain-linked to 2010. In general, good data sources and sound methods are used for the compilation of the national accounts, but measuring activity during the volatile environment of the 2008/09 crisis proved challenging. Moreover, difficulties remain in measuring the non-observed economy. These estimates are compiled at detailed levels of economic activity using fixed coefficients derived from a benchmark surveys conducted in 1996 and 2003, and updated in 2006, and in 2011. According to the most recent updates, the non-observed economy was estimated to be 28.5 percent of GDP in 2012.

Price Statistics: Since December 1998, CPI weights have been updated annually. The monthly CPI is available in the second week following the reference month. The producer price index is calculated according to the chain-linked Laspeyres formula with weights updated every year.

Government Finance Statistics: Data on the central government budget execution are available at a monthly and quarterly frequency. The ongoing treasury project is expected to improve fiscal data quality substantially. However, further work is needed to clarify the treatment of public health care providers and of EU transactions, and the consolidation procedure for government operations. A new methodology, incorporating the GFSM 2014, was adopted in October 2014. Annual and quarterly historical data have been converted into the GFSM 2014 format back to 2010, with data before 2010 still in the GFSM 2001 format. The MoF is reporting to STA general government's annual data on an accrual and cash basis for publication in the Government Finance Statistics Yearbook (GFSY). In addition, the MoF is reporting quarterly and monthly data for publication in the IFS.

Monetary Statistics: The Bank of Lithuania (BoL) reports monetary and financial statistics (MFS) to STA on a timely and regular basis. The scope, concepts and definitions of the MFS are broadly in line with the

guidelines of the Monetary and Financial Statistics Manual (MFSM). Following Lithuania's accession to the European Union, the BoL implemented the ECB framework for compiling and reporting monetary data reflecting the ECB regulations and ESA 2010 on sectorization, valuation and classification of financial instruments.

Balance of Payments: The BoL is responsible for compiling balance of payments, international investment position (IIP), external debt and international reserves statistics. The BoL reports quarterly data on balance of payments, IIP and monthly international reserves to STA on a timely and regular basis. Balance of payments data (on a monthly and quarterly basis) are compiled using the format recommended in the Balance of Payments Manual, sixth edition (BPM6) from 2004 data onwards (data before 2004 still follow the BPM5 methodology). The monthly data correspond to several key balance of payments components, compiled on the basis of a sample survey covering the public sector, commercial banks, and some nonfinancial private sector institutions. The Data Template on International Reserves and Foreign Currency Liquidity is disseminated monthly according to the operational guidelines and is hyperlinked to the Fund's DSBB. Since late 2004, the BoL disseminates quarterly external debt data in the World Bank's Quarterly External Debt Statistics (QEDS) database.

Data Standards and Quality: The authorities publish a range of economic statistics through a number of publications, including the SL's monthly publication, Economic and Social Developments, and the BoL's monthly Bulletin. A significant amount of data is available on the Internet:

- metadata for data categories defined by the Special Data Dissemination Standard are posted on the IMF's DSBB (<http://dsbb.imf.org>);
- the BoL website (http://www.lb.lt/statistical_data_tree) provides data on monetary statistics, treasury bill auction results, balance of payments, IIP, external debt and other main economic indicators;
- the SL website (<http://osp.stat.gov.lt>) provides monthly and quarterly information on economic and social development indicators;
- the MoF (<http://www.finmin.lt>) home page includes data on the national budget, as well as information on laws and privatization; and government finance statistics (deficit, debt);
- NASDAQ OMX Baltic website (<http://www.nasdaqomxbaltic.com/market/?lang=en>) includes information on stock trading at NASDAQ OMX Baltic stock Exchange in Vilnius (the former Vilnius Stock Exchange).

Republic of Lithuania: Table of Common Indicators Required for Surveillance

As of May 7, 2015

	Date of Latest Observation	Date Received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷	Memo Items:	
						Data Quality – Methodological soundness ⁸	Data Quality – Accuracy and reliability ⁹
Exchange Rates	May 7, 2015	May 7, 2015	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	March 2015	April 14, 2015	M	M	M		
Reserve/Base Money	March 2015	April 14, 2015	M	M	M	O, LO, LO, LO	O, O, LO, O, O
Broad Money	March 2015	April 14, 2015	M	M	M		
Central Bank Balance Sheet	March 2015	April 14, 2015	M	M	M		
Consolidated Balance Sheet of the Banking System	March 2015	April 28–30, 2015	M	M	M		
Interest Rates ²	March 2015	April 28–30, 2015	M	M	M		
Consumer Price Index	March 2015	April 12, 2015	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	Q4/2014	April 21, 2015	Q	Q	Q	LO, LO, LO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	March 2015	April 30, 2015	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	March 2015	April 30, 2015	M	M	M		
External Current Account Balance	Q4/2014	March 24, 2015	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	February 2015	April 9, 2015	M	M	M		
GDP/GNP	Q4/2014	February 27, 2015	Q	Q	Q	O, LO, O, LO	O, LO, LO, LO, O
Gross External Debt	Q4/2014	March 20, 2015	Q	Q	Q		
International Investment Position ⁶	Q4/2014	March 20, 2015	Q	Q	Q		

¹ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means

² Both market-based and officially-determined, including deposit and lending rates, discount rates, money market rates, rates on treasury bills, notes and bonds.

³ Foreign, domestic bank, and domestic nonbank financing.

⁴ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and local governments.

⁵ Including currency and maturity composition.

⁶ Includes external gross financial asset and liability position vis-à-vis nonresidents.

⁷ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

⁸ Reflects the assessment provided in the data ROSC published in July 2004, the findings of the mission that took place during September 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

⁹ Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.