

COUNTRY REVIEW

Lithuania



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EULER HERMES COUNTRY RISK GRADE: C

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Low risk of systemic political instability
- Good international relations, EU and NATO membership
- Fairly strong business environment

Weaknesses

- After overheating, the economy has hard landed and will be in a deep, prolonged recession in 2009-2010
- A currency board has largely neutralised monetary policy, leaving fiscal policy as the major tool to steer the economy
- Overly rapid unwinding of previously large macroeconomic imbalances is socially painful
- Fiscal deficit set to rise to about 8% of GDP in 2009
- Bubble in the property market
- High external debt (69% of GDP in 2008, 34% of which was short-term)
- Heavy external debt-service ratio (39% in 2008)
- Modest foreign exchange reserves in relation to annual external debt payments

KEY RISKS

- **Deep, prolonged recession in 2009-2010, with the number of insolvencies to rise sharply**
- **Refinancing risk**
- **Banking sector illiquidity**
- **Exchange rate risk**
- **Transfer risk**

Country Risk Assessment

Ratings	Lithuania		Median Grade C	Bulgaria	Peers	
	Latest	Previous			Russia	Indonesia
Systemic Political Risk:	P1	P1	P3+	P2+	P3+	P3+
Systemic Economic Risk:	E5	E6	E5	E5	E5	E5
ME rating:	ME5	ME6	ME5	ME5	ME5	ME5
<i>Structure</i>	3.3	3.3	5.9	3.3	4.0	4.2
<i>Policy</i>	6.0	5.8	5.2	5.2	6.0	4.3
<i>Solvency</i>	4.2	4.2	2.8	3.8	2.6	5.6
<i>External Liquidity</i>	5.2	6.0	4.3	6.0	4.8	4.2
SBE rating:	SBE2	SBE2	SBE4	SBE3	SBE5	SBE5
COUNTRY GRADE:	C	D		C	C	C

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Vilnius
Population:	3.36 mn (2007)
GDP:	USD 38943 mn (2007)
Currency:	Litas (LTL)
Form of state:	Parliamentary democracy
Head of government:	Prime Minister Andrius KUBILIUS (since November 2008)
Next elections:	Legislative: October 2012 / Presidential: June 2014

Major Industries (% of GDP at market prices, 2008)		Global Assumptions		2008	2009
Services	63.0%	Real GDP grth (% yr/yr) *	1.0	-0.6	
Industry (including construction)	32.0%	Inflation (% , av) *	3.4	1.5	
Agriculture, forestry & fishing	5.0%	Dated Brent (USD/b)	98	55	
* Major economies					

Main Exports (% of total, 2008)		Main Imports (% of total, 2008)	
Mineral products	25.0%	Mineral products	29.5%
Machinery & equipment	10.5%	Machinery & equipment	14.0%
Chemicals	9.5%	Transport equipment	12.0%
Transport equipment	8.5%	Chemicals	9.0%
Lead Export Markets (% of total exports, 2008)		Lead Import Markets (% of total imports, 2008)	
Russia	16.0%	Russia	30.0%
Latvia	11.5%	Germany	11.5%
Germany	7.0%	Poland	10.0%
Poland	6.0%	Latvia	5.0%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	30,106	38,944	47,245	39,787	38,122
Population (mn)	3.39	3.36	3.32	3.32	3.32
GDP per capita (USD)	8,881	11,590	14,231	11,984	11,483
Real GDP growth (% yr/yr)	7.8	8.9	3.0	-14.0	-2.5
Inflation (% , eop)	4.5	8.2	8.5	3.0	2.0
Fiscal balance (ESA 95;% of GDP)	-0.4	-1.0	-3.2	-8.0	-4.8
Current account balance (% of GDP)	-10.7	-14.6	-11.9	0.0	0.0
External debt/GDP (%)	63.0	77.3	68.7	75.4	83.9
External debt/Exports of goods & services (%)	106.7	142.1	113.5	149.9	159.7
Debt-service ratio (%)	27.8	46.9	39.2	42.4	42.6
Foreign exchange reserves (EUR mn)	4,308	5,165	4,457	4,334	4,100
Import cover (months)	3.1	3.2	2.3	3.5	3.1
Exchange rate assumption, LTL:USD (av)	2.75	2.52	2.36	2.56	2.66
Exchange rate assumption, LTL:EUR (av)	3.45	3.45	3.45	3.45	3.45
f: CRU central forecast					

Sources: National Institutions, Government of Lithuania, IMF, ECB, Euler Hermes Country Risk Unit

Political Stability

Lithuania is a well-established democracy with a number of political parties covering a broad spectrum. The risk of systemic instability is relatively low, although changes in government have been frequent since the country's independence from the Soviet Union in 1991, owing to the fractious nature of ruling coalitions. Following the parliamentary election in October 2008, a four-party centre-right coalition government comprising Homeland Union-Lithuanian Christian Democrats (TS-LKD), the National Resurrection Party, the Liberal Movement (LS), and the Liberal and Centre Union replaced the outgoing centre-left government. We expect the general direction of foreign and economic policy to remain largely unchanged, as it has in the past twelve years, notwithstanding the many changes of government. There is a broad consensus among the major parties on pro-Western politics and open market economics. But the major economic target, retention of the existing currency board in order to achieve adoption of the euro as soon as possible, could be tested in the near future. Maintaining the board has required considerable austerity measures amid a sharp economic downturn. In neighbouring Latvia, public discontent over economic hardship owing to a tough austerity programme resulted in widespread and disruptive protest and led to the collapse of government earlier this year. However, the leading party in Lithuania's current coalition government, TS-LKD, came first in national elections to the European Parliament in June 2009 and the LS performed also well. This has reassured the government that a large part of the electorate supports its economic policies.

Generally, international relations are good. EU and NATO membership, two high priority policy goals, were achieved in 2004. Lithuania has also been a member of the WTO since 2001. Tensions with Russia surface from time to time. But NATO membership should neutralise any residual threat to Lithuania's national security. Small Russian and Polish minorities in Lithuania are well integrated and ethnic unrest is unlikely.

Economic Stability

Similar to several other countries in Emerging Europe, the economy has broadly developed along the following pattern in recent years. Rapid credit growth, largely funded by large-scale foreign borrowing of domestic banks from foreign parent banks, fuelled domestic demand (private consumption and investment) and thus boosted real GDP growth. Much of the credit was denominated in foreign currency and directed to real estate, causing exchange rate risk and a housing bubble. Moreover, the booming economy involved soaring wage growth well above productivity increases (partly owing to labour shortages caused by emigration) and elevated inflation to double-digits. Further, imports increasingly exceeded exports, resulting in unsustainably high current account deficits, which had to be financed by new credit, driving up (short-term) external debt. The result of this development was an overheating economy—which inevitably had to cool at some point—with deep macroeconomic imbalances and an ever-rising external financing requirement. The latter has become a particular problem amid the ongoing global financial crisis, as the sudden global liquidity shortage has caused problems in refinancing short-term debt and may result in a domestic banking crisis and/or currency crisis.

Private-sector credit growth was excessive for some time, peaking at 70% yr/yr in mid-2006, and remained unsustainable until at least mid-2008, when it stood at 35%, still twice as much as the median of around 150 emerging economies. Credit growth slowed to a more moderate 11.4% in Q1 2009 and we expect a further reduction in the next quarters.

Real GDP growth has decelerated rapidly from 8.9% in 2007 to 3% in 2008. The economy slid into a deep recession in the first half of 2009, as GDP contracted by 18.1% yr/yr (13.3% in Q1, 22.4% in Q2, advance estimates). The downturn was broadly based. Industrial output shrank by 13.6% yr/yr in Q1 and 20.4% in Q2. The contraction in retail sales eased slightly from 30% yr/yr in Q1 to 27.7% in Q2, indicating that the decline in the domestic economy may be bottoming out. We expect real GDP to contract by about 14% in 2009 as a whole and by another 2.5% in 2010.

Lithuania has had a currency board since 1994, under which the local currency, the litas (LTL) is now pegged to the EUR at a rate of 3.4528 LTL/EUR within the EU's Exchange Rate Mechanism II (ERM-II, a 2-year waiting room prior to entry to the European Monetary Union—the euro zone). Two aspects have recently raised some concern about the stability of the currency board. First, analysis of the real effective exchange rate suggests that in March 2009 the LTL was about 15% overvalued as compared to the average of the previous 60 months, up from just 2.5% in November 2008. Secondly, speculation about a potential currency devaluation in neighbouring Latvia increased in early June, suggesting contagion risk for Lithuania. However, there are also considerable positives. The currency board arrangement requires that the monetary base is fully backed by the foreign exchange (FX) reserves of the BoL. This requirement has not been tested so far, and at end-June 2009 FX reserves

covered 142% of the monetary base, up from 121% at end-2008. Moreover, the government continues to underscore that it has a firm commitment to defend the currency board. It has retained the view that devaluation now would be more costly than maintaining the current system. Further, the ECB agrees on retention of the board as the preferred route for Lithuania on its way to euro adoption.

Inflation peaked at 12.5% yr/yr in June 2008 but has gradually fallen to 4.2% in June 2009. We expect a further decline to 3% or so at end-2009 and an average inflation of about 5.3% in 2009.

Since the currency board has largely neutralised monetary policy, fiscal policy is the major tool to steer the economy. Seemingly prudent fiscal policy in recent years, with fiscal deficits around 1% of GDP until 2007, however, was not tight enough to cool the overheating economy. The fiscal deficit rose quickly to 3.2% of GDP in 2008, as sharply lower growth led to lower revenues. The severity of the recession in 2009 has meant that the government is faced with a policy dilemma of either applying a fiscal stimulus or curtailing the fiscal deficit. It has so far opted for the latter, which is needed to maintain investor confidence in the currency board. The commitment to the board extends to taking necessarily painful domestic adjustment that the rigidity of the fixed exchange rate imposes. Fiscal measures already taken amount to about 7% of GDP. The government reports that it has won the agreement of labour unions on wage cuts and it has also been prepared to cut pensions. Even so it has continued to maintain public support so far, reflected in its good performance in the June elections to the European Parliament. There has also been some expenditure switching within the budget to provide support to industry, implying recognition of the need to target scarce resources. The fiscal deficit is expected to rise to about 8% of GDP in 2009. Lithuania also successfully placed a five-year EUR500mn Eurobond in June—albeit with a relatively high coupon of 9.375%—and plans to issue another external bond later in the year. Public debt may increase from 15.6% of GDP in 2008 to 25% or so this year which, however, is still moderate by EU standards.

The current account deficit eased from 14.6% of GDP in 2007 to 11.9% in 2008. On a quarterly basis, the deficit has narrowed rapidly from a peak of 18.7% of GDP in Q1 2008 to 3.8% in Q4 and the current account was balanced in Q1 2009 as imports plunged by more than exports. Net foreign direct investment (FDI) inflows have been negative in Q1. Since external financing will remain difficult in the remainder of this year, the current account is forecast to turn out near-balanced.

FX reserves reached a peak of EUR5.6bn in October 2007 and have since fallen by about 22% to EUR4.3bn in June 2009. The decline has been fairly gradual, with monthly changes not exceeding $\pm 11\%$. Most recently, reserves increased again by 6.5% mth/mth in June. The coverage of imports through FX reserves fell from 3.2 months in 2007 to a relatively low 2.3 months in 2008, but we expect it to rise again to more than three months in 2009 as imports decline sharply this year.

Gross external debt reached a peak of USD35.5bn in Q2 2008 but fell to USD30bn in Q1 2009. However, the external debt burden in relation to GDP (exports) will continue to increase from 69% (113%) in 2008 to about 75% (150%) this year, as both GDP and exports will contract sharply. Total short-term external debt accounted for 31% of gross debt in Q1. Even taking into account the considerable assets held abroad by Lithuanian institutions, the debt position now appears critical: Net external debt rose from just 15% of GDP in 2005 to 34% in 2008. External debt-servicing will become more difficult, having risen from 16% of export earnings in 2005 to 39% in 2008, a level that is also forecast in 2009. Total external debt payments due in 2009 (short-term debt and principal repayments) are estimated to be almost three times the level of current FX reserves. This poses significant roll-over risk as the refinancing of maturing external debt will remain difficult amid the ongoing global financial crisis, and disruptions in the banking and corporate sectors cannot be ruled out.

Banking sector risk has increased. Although the Scandinavian banks that have funded much of Lithuania's external imbalance would be reluctant to choke off financing suddenly, they might be forced to do so at some point of time as their position has weakened over the past months, mainly because of their exposure to their Baltic subsidiaries. The foreign-currency exposure of Lithuanian borrowers is high as about 65% of private-sector debt is denominated in EUR.

Structural Business Environment

Apart from the banking sector, the Structural Business Environment is assessed as strong. Lithuania ranks 32nd out of 210 economies in our assessment overall, just behind Spain and ahead of South Korea and Latvia.

Country Risk Unit

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Charts

