

COUNTRY REVIEW

Lithuania



13 December 2010

ANALYST: Dr. Manfred Stamer

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
- Access to international capital markets
- Fairly strong business environment

Weaknesses

- Modest recovery after deep recession in 2009
- 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 has been socially painful
- Still high fiscal deficit
- High external debt burden
- Modest foreign exchange reserves in relation to annual external debt payments
- Banking sector vulnerability

KEY RISKS

- **Refinancing risk**
- **Exchange rate risk (collapse of currency board due to contagion)**

Country Risk Assessment

Ratings	Lithuania		Median Grade B	Median Grade C	Peers	
	Latest	Previous			Croatia	Hungary
Systemic Political Risk:	P1	P1	P2-	P3+	P2-	P2-
Systemic Economic Risk:	E4	E5	E4	E5	E4	E5
ME rating:	ME4	ME5	ME4	E5	ME4	ME5
<i>Structure</i>	4.0	3.3	4.7	5.8	3.3	2.3
<i>Policy</i>	4.2	6.0	4.5	5.2	2.9	5.3
<i>Solvency</i>	4.2	4.2	2.3	2.9	4.8	3.9
<i>External Liquidity</i>	3.8	5.2	3.3	4.5	5.2	6.0
SBE rating:	SBE2	SBE2	SBE3	SBE4	SBE3	SBE2
COUNTRY GRADE:	C	C			B	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 Economic Studies

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Vilnius
Population:	3.339 mn (2009)
GDP:	USD 37103 mn (2009)
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, 2009)	Global Assumptions	2010	2011	
Services	69.0%	Real GDP grth (% yr/yr)	3.3	2.9
Industry (including construction)	27.0%	Inflation (% av) *	1.2	1.4
Agriculture, forestry & fishing	4.0%	Dated Brent (USD/b)	75	70
		* Major economies		

Main Exports (% of total, 2009)		Main Imports (% of total, 2009)	
Mineral products	21.5%	Mineral products	29.0%
Machinery & equipment	10.0%	Machinery & equipment	13.2%
Chemicals	9.1%	Chemicals	12.3%
Transport equipment	7.3%	Transport equipment	6.5%
Lead Export Markets (% of total exports, 2009)		Lead Import Markets (% of total imports, 2009)	
Russia	13.2%	Russia	29.9%
Latvia	10.1%	Germany	11.3%
Germany	9.7%	Poland	10.0%
Poland	7.2%	Latvia	6.4%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	39,154	47,114	37,103	35,861	35,465
Population (mn)	3.38	3.36	3.34	3.32	3.30
GDP per capita (USD)	11,598	14,030	11,112	10,805	10,750
Real GDP growth (% yr/yr)	9.8	2.9	-14.7	0.2	3.0
Inflation (HICP; %, eop)	8.2	8.5	1.2	3.1	2.0
Fiscal balance (ESA 95; % of GDP)	-1.0	-3.3	-8.9	-7.8	-6.5
Public debt / GDP (ESA 95; %)	16.9	15.6	29.3	39.0	41.0
Current account balance (% of GDP)	-14.5	-11.9	4.0	2.9	2.0
Gross external debt / GDP (%)	76.9	68.9	89.5	80.4	84.6
Net external debt / GDP (%)	31.9	34.2	41.9	37.7	42.3
Gross external debt / Exports of goods & services (%)	142.1	113.5	163.8	120.2	126.1
Debt-service ratio (%)	46.9	38.8	44.3	56.1	45.8
Foreign exchange reserves (EUR mn)	5,165	4,458	4,345	4,300	4,500
Import cover (months)	3.2	2.3	3.5	2.8	2.8
Exchange rate assumption, LTL:USD (av)	2.52	2.36	2.48	2.60	2.76
Exchange rate assumption, LTL:EUR (av)	3.45	3.45	3.45	3.45	3.45
f: CRU central forecast					

Sources: National figures, IMF, ECB, Eurostat, World Bank, Euler Hermes Economic Studies

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 (TPP), the Liberal Movement (LS), and the Liberal and Centre Union (LCS) replaced the outgoing centre-left government. It originally had a large majority, but this has eroded with the defection of a number of deputies to the opposition. Since March 2010 the coalition has been in a minority in parliament, with 69 out of 141 seats. So far PM Andrius Kubilius of the TS-LKD (the largest party in the coalition) has been fairly successful in moderating coalition disagreements and seeking informal support from non-coalition deputies on key legislation. However, there is a risk that the government will not survive until the next parliamentary election, scheduled for October 2012. Reportedly there is also growing public discontent with the harsh austerity measures that have been introduced since late 2008, required in order to retain the existing currency board amid a sharp economic downturn. Public-sector wages have been cut considerably and unemployment has risen to 18.3% in Q2 2010. Nonetheless, we do not expect a significant change to the general direction of foreign and economic policies as there is a broad consensus among the major parties on pro-Western politics, open market economics and retention of the currency board in order to achieve adoption of the euro as soon as possible.

International relations are generally 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

The World Bank classifies Lithuania as an upper middle income country, with GNI per capita of USD11,410 in 2009. The economy is quite advanced, with services accounting for about 69% of GDP, industry 27% and agriculture 4%. However, the export structure is somewhat unfavourable: In 2009, Russia accounted for 13% of Lithuania's merchandise exports, Latvia 11% and all fellow members of the EU-27 together for 59%, making the economy vulnerable to the business cycles of these economies. Real GDP grew by an average annual 8% in 2001-2007, however, in large part this was due to an overheating of the economy, which was reflected in mounting macroeconomic imbalances such as an excessive credit boom that fuelled domestic demand and caused a housing bubble, elevated inflation and unsustainably high current account deficits. In the wake of the global financial and economic crisis, this growth model collapsed and the economy fell into deep recession, with an output decline of 14.7% in 2009.

Real GDP continued to contract by 2% yr/yr in Q1 2010, but returned to growth of 1.1% in both Q2 and Q3 (the first increases since Q3 2008). The rebound was led by strong external demand, but domestic demand improved in Q3 thanks to investment which expanded by 15% yr/yr after nine consecutive quarters of contraction. The decline in private consumption moderated to 0.9% yr/yr in Q3 from 8.2% in Q2 while the government cut spending more sharply in Q3, by 2.4%, than in the preceding quarter (1.7%). Export growth slowed to 14.6% in Q3 from 21.3% in Q2, while import growth accelerated to 20.2% from 15.6% in Q2. We forecast real GDP growth of about 0.2% in calendar 2010 and 3% in 2011.

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 of this raised some concern about the stability of the currency board in Q2 2009. First, analysis of the real effective exchange rate suggested that in February 2009 the LTL was about 16% overvalued as compared to the average of the previous 60 months, up from just 2.5% three months earlier. Secondly, speculation about a potential currency devaluation in neighbouring Latvia increased in June 2009, suggesting contagion risk for Lithuania. However, Lithuania's currency board has withstood the pressures from the regional and the global financial crises remarkably well. The currency board arrangement requires that the monetary base is fully backed by the foreign exchange (FX) reserves of the central bank. This requirement has not been tested so far, and at end-October 2010, FX reserves covered 139% of the monetary base, up from 121% at end-2008. Meanwhile, the real effective exchange rate overvaluation (as compared to the previous 60 months) has decreased to a modest 2.2% in September 2010. Moreover, the government has continued 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. Downside risks to the central case scenario, that the currency board holds, include a loss of domestic confidence in the banking system and contagion from other crises.

'Internal devaluation', i.e. massive real wage cuts and sharp fiscal tightening, helped to reduce inflation gradually from a peak of 12.7% yr/yr (on the EU's HICP) in June 2008 and, combined with the sharp decline in domestic demand, shifted it to modest deflation in Q1 2010. Since then, inflation has accelerated again, partly owing to base effects, and stood at 2.8% yr/yr in November 2010. We expect annual average inflation of about 2% in 2011.

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 the median of around 150 emerging economies. Then, in the wake of the sharp global liquidity tightening, credit growth slowed rapidly and annual private sector credit has been contracting since Q3 2009, a necessary adjustment which, however, has affected economic recovery.

Since the currency board has largely neutralised monetary policy, fiscal policy is the major tool to steer the economy. Seemingly prudent fiscal policy, with annual fiscal deficits around 1% of GDP from 2002 to 2007, however, was not tight enough to cool the overheating economy. In the wake of the economic downturn in 2008-2009, as sharply lower growth led to lower revenues, the fiscal deficit rose rapidly to 3.3% of GDP in 2008 and 8.9% in 2009. But the ratio would have been even higher, had the government not opted for sharp fiscal tightening in 2009 in order 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 taken in 2009-2010 amount to about 10% of GDP. The focus has been on the expenditure side so far—initially broad-based spending cuts, later more targeted reductions in wages, pensions and other benefits that were agreed with social partners. The 2010 fiscal deficit is likely to come in at close to 8% of GDP. The government targets a further reduction of the deficit to 5.8% in 2011 and 3% in 2012. In order to achieve these objectives, additional measures on the revenue side will be needed. The seemingly appropriate fiscal adjustment to date was rewarded with access to international bond markets at declining cost—the latest placements were a USD2bn, ten-year Eurobond in February 2010 and a USD750mn, seven-year bond in September. Public debt has increased from 15.6% of GDP in 2008 to 29.3% in 2009 and is set to exceed 40% in 2011. However, this is still moderate by EU and emerging markets standards.

The current account swung from a deficit of 11.9% of GDP in 2008 to a 4% surplus in 2009, as imports (in line with domestic demand) contracted even sharper than exports. We forecast the current account to remain in surplus in 2010-2011, though it is likely to ease gradually as imports will grow faster than exports in the next few quarters.

FX reserves reached a peak of EUR5.6bn in October 2007 but fell by about 28% to EUR4bn in April 2009. Since August 2009, the level of reserves has been somewhat higher overall, though quite volatile on a monthly basis, hovering around an average of EUR4.5bn, which covers slightly less than three months of imports.

Gross external debt reached a peak of USD35.5bn in Q2 2008 but has fallen to USD28.6bn in Q2 2010. The external debt in relation to GDP is relatively high at about 80%, though it looks more adequate in relation to export earnings, at about 120%. Even taking into account the considerable assets held abroad by Lithuanian institutions, the debt position appears critical. Net external debt rose from just 15% of GDP in 2005 to 42% in 2009 and is forecast to remain around that ratio in 2010-2011. External debt-servicing has become more difficult as export earnings have sharply fallen in the wake of the crisis. The debt-service ratio was 44% in 2009 and is forecast at about 56% 2010 and 45% in 2011. Total external debt payments (short-term debt and principal repayments) due in 2011 are estimated to be almost three times the level of current FX reserves. As a result, there is still significant roll-over risk as the refinancing of maturing external debt will remain difficult amid still tight lending conditions. Disruptions in the banking and corporate sectors cannot be ruled out yet.

Structural Business Environment

The Structural Business Environment is generally strong. Lithuania ranks 44th out of 212 economies in our assessment overall, just behind Spain and ahead of Portugal and Latvia.

However, the banking system has revealed considerable vulnerability during the global financial crisis, even though financial sector stability was preserved thanks to liquidity support measures taken by the authorities and support by foreign parent banks to their subsidiaries which account for about 85% of

the Lithuanian banking sector. Meanwhile, capital adequacy and liquidity ratios in the banking sector are well above regulatory minima and the IMF reports that credit is available for sound, profitable borrowers, even though overall credit growth is still negative (see above). But despite these tentative signs of improvement, banking sector risk remains elevated. Banks made large losses in 2009 and the sector as a whole was not yet profitable in Q1 2010. The ratio of nonperforming loans to total non-interbank loans was still high at 19.2% in March 2010, up from 4.6% in 2008. The share of foreign-currency-denominated loans to total non-interbank loans has increased from 65% in 2008 to 74% in Q1 2010.

Dr. Manfred Stamer

Hamburg: +49 (0)40 8834 3607

Charts

