Euler Hermes Economic Research

Country Report

Lithuania

Joining the Eurozone in 2015 while geopolitical tensions remain

General Information

GDP	USD42.2 bn (World ranking 84, World Bank 2012)
Population	3.0 mn (World ranking 137, World Bank 2012)
Form of state	Parliamentary Democracy
Head of government	Algirdas BUTKEVICIUS
Next elections	2016, legislative

Strengths

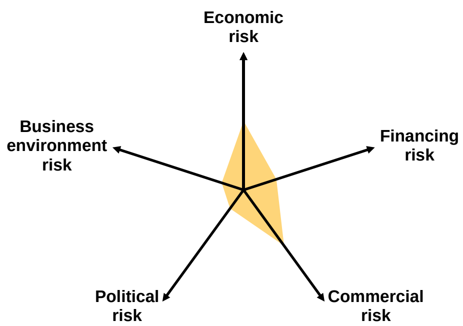
- Low systemic political risk
- Good international relations, EU and NATO membership. Eurozone accession in January 2015
- Low inflation
- Current account surplus
- Access to international capital markets
- Strong business environment
- Flexible economy, rebalanced post Great Recession

Weaknesses

- High external debt burden
- The industry is dominated by one large refinery complex, Orlen Lietuva (formerly known as Mazeikiu Nafta), which accounts for around 20% of total industrial output and 25% of total exports
- Banking sector vulnerability
- High export and import dependence on Russia, especially on crude oil imports

Country Rating

BB2



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Russia	18%	1	32%	Russia
Latvia	11%	2	9%	Germany
Estonia	8%	3	9%	Poland
Germany	7%	4	6%	Latvia
Poland	6%	5	5%	China

By product (% of total)

Exports		Rank		Imports
Refined Petroleum Products	27%	1	22%	Crude Oil
Plastic Articles	5%	2	5%	Natural Gas
Other Edible Agricultural Prod	5%	3	4%	Refined Petroleum Products
Furniture	4%	4	3%	Plastic Articles
Fertilizers	4%	5	3%	Basic Organic Chemicals

Source: Chelem (2012)

Economic Overview

Growth expected to remain solid ...

Following the severe recession in 2009 (contraction of -14.8%) a solid recovery started in mid-2010, resulting in average annual growth of +3.7% in 2010-2013. In 2014, real GDP growth posted +3.3% y/y in Q1 and +3.4% in Q2 before slowing to +2.7% in Q3, mainly as a result of a sharp drop in inventories. Robust private consumption and strong fixed investment have been the main growth drivers in the first three quarters of 2014, increasing by an average +5.4% and +10.3% y/y, respectively. Net exports made a small negative contribution to Q1-Q3 growth as imports (+3.8% y/y) grew faster than exports (+2.8%). Going forward, Russian sanctions and geopolitical tension are expected to affect export performance and dampen consumer and investor confidence until mid-2015 or so. Nonetheless, domestic demand should remain the main growth engine. Euler Hermes forecasts full-year GDP growth of +3% in 2014 and +2.8% in 2015.

... but exposure to Russia poses downside risk

Russia is Lithuania's main trade partner, accounting for 18% of Lithuanian exports and 32% of imports, making the economy vulnerable to the Russian business cycle and sanctions. In particular, crude oil imports from Russia (accounting for 22% of total imports) to Orlen Lietuva (formerly known as Mazeikiu Nafta) are crucial. The oil refinery, terminal and pipeline complex is the largest single contributor to the Lithuanian economy and an important source of export revenue (mineral products account for one fourth of exports). Supply disruptions to Mazeikiu Nafta have already temporarily affected growth several times in the past.

Exports of Lithuanian goods to Russia fell by -12.8% y/y in Q1-Q3, however, total exports to Russia increased by +9.1% y/y owing to the large share of re-exports (88%) of non-Lithuanian goods, so that overall export growth has remained robust so far. Nonetheless, downside risks to our growth forecast remain. Should the conflict between the EU and Russia over Ukraine seriously escalate in the next six months (Euler Hermes assigns a probability of 30% to such a scenario), growth in Lithuania could be markedly lower in 2015, by up to -2pps.

Inflation is very low but credit growth remains negative

Owing to subdued energy and food price developments, consumer price inflation fell to an average 0.1% in the first 10 months of 2014 (from 1% in 2013) and stood at 0.1% y/y in October, after briefly dipping into deflation territory in September. Inflation is expected to remain low until early 2015 before picking up somewhat on the back of lasting wage growth in the service sector.

Despite low inflation and interest rates, private sector credit growth has remained in negative territory and stood at -1.4% y/y in July 2014, as the private sector has continued deleveraging.

Fiscal position is adequate

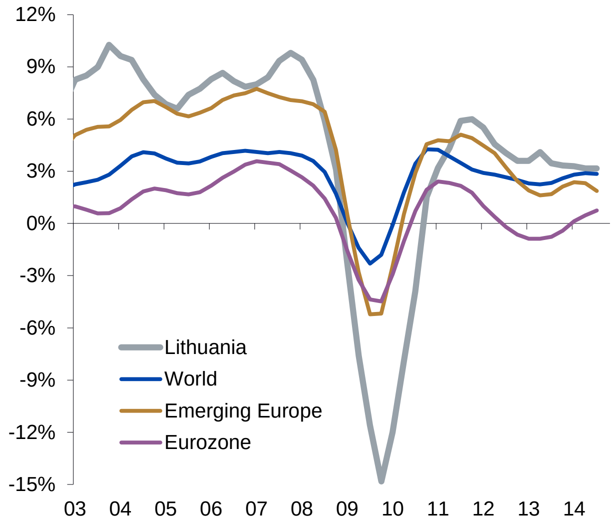
The impressive rebalancing of the Lithuanian economy after the deep recession in 2009 was achieved through "internal devaluation", i.e. massive real wage cuts and sharp fiscal tightening. The fiscal deficit has been reduced from -9.3% of GDP in 2009 to -2.6% in 2013 and is forecast at around -1.5% in 2014 and -2% in 2015. Financing such deficits is not a problem as Lithuania has long regained access to international bond markets. Gross public debt has risen from just 15% of GDP in 2008 to slightly above 40% but should stabilise around that ratio.

Key economic forecasts

	2012	2013	2014f	2015f
GDP growth (% change)	3.8	3.3	3.0	2.8
Inflation (%, end-year)	2.8	0.4	0.2	1.6
Fiscal balance (% of GDP)	-3.2	-2.6	-1.5	-2.0
Public debt (% of GDP)	39.9	39.0	42.0	42.5
Current account (% of GDP)	-1.2	1.6	1.8	0.5
External debt (% of GDP)	77.8	69.7	70.0	71.0

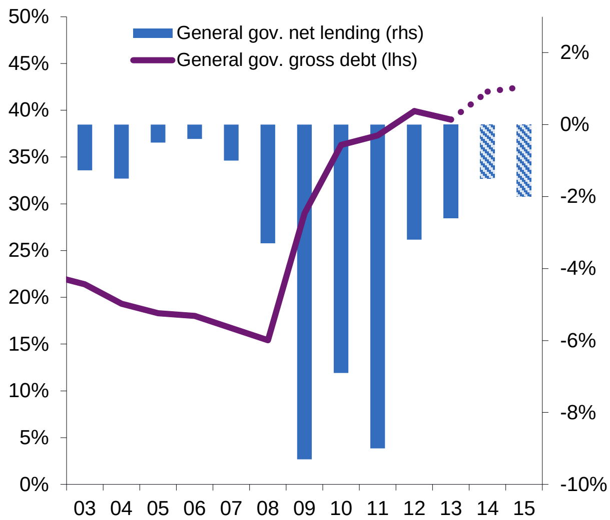
Sources: National sources, IHS, Euler Hermes

GDP growth (% y/y, 4 qtrs cumulated)



Sources: National sources, IHS, Euler Hermes

Fiscal balance and public debt (% of GDP)



Sources: National sources, IHS, Euler Hermes

Currency board has remained resilient

Lithuania's currency board has withstood the pressures from the 2008-2009 regional and global financial crises remarkably well. Thanks to the "internal devaluation" process (see above) the country regained international competitiveness, as reflected in the elimination of the real effective overvaluation of the LTL, which exceeded 10% for most of 2009 (peak 16% in February 2009).

Eurozone accession in January 2015

Thanks to the strong economic policy track record after the Great Recession, Lithuania fulfilled all five Maastricht criteria – including exchange rate stability – for accession to the Eurozone by mid-2014 and was permitted to adopt the EUR at the start of 2015. Although the Eurozone crisis is not fully overcome yet, the IMF agrees with Lithuanian authorities that EUR adoption will be beneficial for the country. One concrete advantage will be that Lithuania's relatively low foreign exchange reserves (covering only 2.5 months of imports or just 37% of annual external debt payments) will be replaced by access to ECB liquidity.

Current account to remain in surplus

The current account shifted into a surplus of 1.6% of GDP in 2013, thanks to a narrowing trade deficit and an improving surplus in the transfers balance. In Q1-Q3 2014 the current account recorded a surplus of EUR548 mn and Euler Hermes expects a full-year surplus of 1.8% of GDP or so, followed by a surplus of around 0.5% of GDP in 2014.

External debt remains relatively high

The external debt burden surged to a worrisome level of 84% of GDP in 2009, built up by the earlier large current account deficits. Although the ratio has declined to about 70% currently, it is still high and remains a cause of some concern.

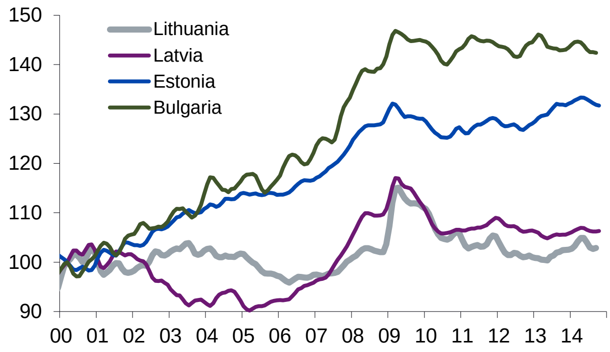
Low risk of a systemic crisis

Overall external liquidity risk has continued to decline, and access to ECB liquidity thanks to Eurozone accession is a clear positive. Still, the refinancing or repayment of maturing external debt may prove difficult for some companies amid still tight credit markets, especially in the event of an external shock, as reflected in the still elevated number of corporate insolvencies. However, the risk of a systemic financial crisis is low.

Insolvencies remain at elevated level

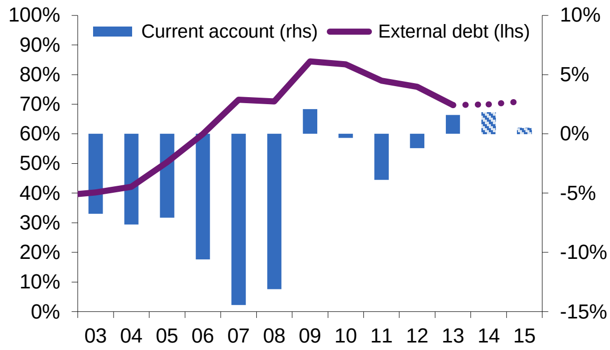
Following a -4% decrease in the number of business failures to around 1,490 cases in 2014, Euler Hermes expects another -4% decline to 1,430 cases in 2015 in its baseline scenario. This will be still twice as much as the average annual 692 cases recorded in 2000-2008.

Real effective exchange rate (2000 = 100)



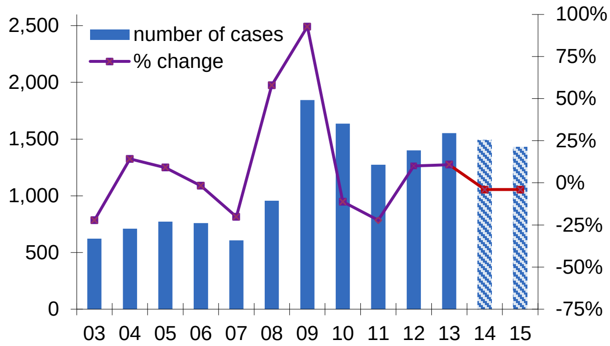
Sources: National sources, ECB, Euler Hermes

Current account and external debt (% of GDP)



Sources: National sources, IHS, Euler Hermes

Insolvencies



Sources: National sources, Euler Hermes

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